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In the Supreme Court of the United States

OCTOBER TERM, 1991

EDWARD CRESSWELL; AGRICONSULTANTS INCORPORATED; AMERICAN GROWTH PROPERTIES MANAGEMENT COMPANY LTD.; ERIC APPLETON; BERFORS FINANCE LTD.; JOHN BIRD; NORA BIRD; PETER BURKHARDT; JOHN A. L. CHETTOE; DENNIS R. DUDENEY; V. S. DWIVEDI; LARS FEUK; FLETCHER INVESTMENTS LTD.; JOHN H. FLETCHER; NOEL FOX; STUART J. GARDINER; F. GEORGE; KENNETH E. F. GEORGE; VERITY ANNE GIBBONS; POLLY GREGORY; A. D. HARRIS; DAVID G. HART; JOHN M. HAWKINS; PATRICIA HAWKINS; SPENCER HAYES; HILARY CORPORATION, INC.; ANTHONY HYDE; IZRADA, S.A.; GORDON WALTER JAMES; JOVAL INVESTMENTS LTD.; JAD KABBAN; ESTATE OF PHILIP J. KNIGHT; PIERRE LAMARCHE; ROGER LANDAU; ANDREW LEWIS; JAMES J. MATHER; MALCOLM MILTON; GREGOIRE MOZDYNIEWICZ; COLLIN DAVID PARKER; PEZCO OVERSEAS, INC.; JOHN PIRIE; A. REMINI; JULIA A. ROBIN; ROGER Y. ROBIN; CLAUDINE SEIKALY; JOHN B. SHAW; ROBERT W. SHIELDS; SIANPLAN LIMITED; REGINALD E. SILLETTO; BASILIA L. W. ABEL SMITH; DAVID F. SMITH; ALEC SNOBEL; GEOFFREY W. SUTCLIFFE; JAN WALLIN; PATRICIA WILKINSON, as Executrix, and GORDON WILSON,

Petitioners,

vs.

SULLIVAN & CROMWELL,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

David S. Brown
COOPER, BROWN & BEHRLE, P.C.
Attorneys for Petitioners
30 Rockefeller Plaza
New York, New York 10112
(212) 957-9000

QUESTIONS PRESENTED

1. If attorneys repeatedly conceal material evidence during federal discovery, doing so with fraudulent intent year after year, and if their scheme culminates in a settlement and Judgment, have such officers of the court practiced a "fraud upon the court"?

2. May attorneys who practice "fraud upon the court" escape liability by showing that their victims' attorney continued to believe their fraudulent misrepresentations when presented with information which might have contradicted them?

LIST OF ALL PARTIES AND RULE 29.1 NOTATION

There were no parties to the proceeding in the Court whose judgment is sought to be reviewed, other than those listed in the caption of the case.

There are no parent or subsidiary companies to be listed pursuant to Rule 29.1.

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Petitioners,

vs.

SULLIVAN & CROMWELL,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit.

REPORTS OF OPINIONS

The Opinion delivered upon the decision sought to be reviewed is that of the United States Court of Appeals for the Second Circuit, dated February 25, 1992, a copy of which is annexed as pp. 1a-8a of the Appendix. This Opinion is not officially reported.

The Opinion of the United States District Court for the Southern District of New York herein, as amended July 24, 1991, is annexed hereto as pp. 9a-28a of the Appendix and is reported at 771 F. Supp. 580.

The Opinion of the United States Court of Appeals for the Second Circuit herein,

dated December 10, 1990, is annexed hereto as pp. 29a-58a of the Appendix and is reported at 922 F.2d 60.

The Opinion of the United States District Court for the Southern District of New York, dated January 11, 1989, is annexed hereto as pp. 59a-116a and is reported at 704 F. Supp. 392.

STATEMENT OF JURISDICTION

The date of entry of the judgment or decree sought to be reviewed was February 15, 1992 (infra, p. 1a). No petition for rehearing was sought.

In a prior Opinion herein, the United States Court of Appeals concluded (infra, pp. 52a, 46a-52a), that the Court had "ancillary equitable jurisdiction over the present claims," such jurisdiction being ancillary to a judgment entered in

a previous action in which federal question jurisdiction existed (infra, pp. 46a, 49a). The savings clause of Fed. R. Civ. P. 60(b) provides: "This rule does not limit the power of a court to entertain an independent action to relieve a party from a judgment ... or to set aside a judgment for fraud upon the court."

The jurisdiction of this Court to review the judgment of the Second Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Fed. R. Civ. P. 60(b). Relief From Judgment or Order -- Mistakes; inadvertence; excusable neglect; newly discovered evidence; fraud, etc.

On motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final

judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order, or proceeding

was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation. This rule does not limit the power of a court to entertain an independent action to relieve a party from a judgment, order, or proceeding, or to grant relief to a defendant not actually personally notified as provided in Title 28 U.S.C., § 1655, or to set aside a judgment for fraud upon the court. Writs of coram nobis, coram vobis, audita querela, and bills of review and bills in the nature of a bill of review, are abolished, and the procedure for obtaining any relief from a judgment shall be by motion as prescribed in these rules or by an independent action.

STATEMENT OF THE CASE

This case squarely holds, for the first time in American jurisprudence, that attorneys can safely engage in discovery frauds if they can show that the opposing attorney "believed what he had been told ..., even when he was presented with information which might have contradicted those representations." Opinion of the District Court herein, p. 10, infra; emphasis added.

In 1983, a group of investors brought suit ("Cresswell I") complaining of marketing practices by Prudential-Bache Securities, Inc. ("Bache"). In 1987, in a federal Complaint ("Cresswell II"), these investors alleged that Cresswell I had been settled through fraudulent inducement by Bache and its attorneys, Sullivan & Cromwell ("S&C").

The fraud alleged was that beginning with the discovery phase of Cresswell I, attorneys at S&C deliberately concealed the fact that the New York Stock Exchange (NYSE) was conducting a serious persistent inquiry (the "Exchange Inquiry") into the very marketing practices of Bache that had been complained of in Cresswell I. After Cresswell I had been settled, allegedly fraudulently, the Exchange Inquiry culminated in a censure and a fine imposed by the NYSE upon Bache.

In 1989, the District Court granted summary judgment dismissing Cresswell II, (pp. 59a-116a, infra). The Court sought to apply the standards of common-law fraud. It held (e.g., pp. 19-20, infra) that a jury could reasonably find clear and convincing proof of both fraudulent intent of attorneys at S&C in their conduct of the case and also of materiality.

That proof is summarized at pp. 11-19, infra. The District Court further held, however, that even if plaintiffs' attorney, Swan, had relied upon S&C's fraudulent misrepresentations, such reliance was unreasonable (p. 109a, infra).

On appeal, the Court of Appeals, sua sponte, considered the question of federal jurisdiction. It concluded that there was neither diversity nor federal question jurisdiction, but that the District Court had "'ancillary' equitable jurisdiction" to entertain the action by way of an independent action in equity, ancillary to the original Judgment on consent in Cresswell I (pp. 51a-52a, infra; see also, Statement of Jurisdiction, supra). The Court of Appeals vacated the dismissal of the claims against S&C and "remanded to permit the district court to consider those claims as a court of equity" (p. 58a, infra).

Although S&C had not been a party to Cresswell I, the Court of Appeals held that "parties who seek to vacate a judgment on the grounds of fraud on the court are allowed to join as defendants in the second suit persons who were attorneys, not parties, in the first suit" (p. 52a, infra; emphasis added). But despite this express and necessary application of the doctrine of "fraud on the court," the Court of Appeals failed to follow Hazel-Atlas Glass Co. v. Hartford Empire Co., 332 U.S. 238, 246 (1944). In Hazel-Atlas, this Court held that fraud on the court "cannot be condoned" even if the victim is not diligent because "it cannot be that preservation of the integrity of the judicial process must always wait upon the diligence of litigants." The Court of Appeals here held (p. 54a, infra): "Most important for purposes of the present case is the principle that in

order to obtain the requested relief, a plaintiff must show 'the absence of fault or negligence' on his own part" (citing cases that did not involve fraud on the court).

On the remand, plaintiffs argued that fraud by officers of the Court, (here, attorneys) in the conduct of a case, is a well recognized example of "fraud on the court." The District Court, however, held that "the Court of Appeals' decision not to view the plaintiffs' equitable fraud claim as one for fraud on the court is more than amply supported ..." (p. 24a, infra). Accordingly, the District Court again summarily dismissed the complaint, finding that plaintiffs' former attorney, Swan, "merely re-emphasises that he believed what he had been told by S & C, even when he was presented with information which might have contradicted those representations" (p. 25a, infra).

Summary judgment was affirmed by the Court of Appeals without further discussion of the substantive law of fraud on the court (pp. 4a-7a, infra).

* * *

For purposes of summary judgment, the inference had to be, and was, drawn by the Court that over a period of years, officers of the Court fraudulently concealed material evidence from plaintiffs, from other claimants and from the Court. (This is demonstrated beginning here and continuing to p. 20, infra.)

The District Court found sufficient proof that these frauds were intentional upon considering the different attorneys and plaintiffs sought to be misled, the deceit in Open Court, the impossibility of endless error and the adamant determination and purpose of these attorneys not to divulge evidence.

(1) In 1983, S&C formally stated that all documents would be produced, but failed to produce documents relating to the Exchange Inquiry (p. 7, supra).

The Cresswell I plaintiffs served their second document request (the "Request"), ¶ 1 of which called for "[a]ny and all documents relating to any investigation or inquiry by any exchange ... relating to defendant's marketing ... which is the subject of this action."

S&C responded to the Request, stating that "Bache will produce documents responsive to this ... request." Documents were produced, but none related to any NYSE inquiry.

Marvin Schwartz, Esq., a partner at S&C, testified that he saw the Request when it was served. Mr. Schwartz testified that he made a conscious decision not to produce the documents relating to

the Exchange Inquiry and discussed the question and his decision with John L. Hardiman, Esq., then an associate. S&C's response bore the signatures of Messrs. Schwartz and Hardiman. S&C now admits that prior to service of the Request, it had received virtually all the documents relating to the Exchange Inquiry.

(2) By July 1984, Mr. Schwartz must have recognized his error in failing to produce as demanded.

The District Court found (pp. 71a, 102a, infra):

> At his deposition ..., Schwartz testified that in December 1983, before responding to the ... Request, he and Hardiman discussed whether production of documents relating to ... the NYSE was required. According to Schwartz, they decided that the documents

did not relate to an "investigation or inquiry" by an exchange within the meaning of the Request.

...

... [B]y July 1984 [however, S&C] knew that even under its own narrow interpretation of the ... Request its earlier response was inaccurate or incomplete. A duty to amend the response at that point existed.

Mr. Schwartz admitted that a July 1984 letter from the NYSE to Bache "made it plain that the department of enforcement was conducting an investigation," so that withholding on the basis that the Exchange Inquiry documents "did not relate to an [NYSE] 'investigation or inquiry,'" could no longer be justified.

(3) Between the summer of 1984 and February 1985, S&C settled with Swan

without revealing that it then knew its representation to have been untrue.

All but two Cresswell I plaintiffs agreed to settle by February of 1985. "[O]ne who, after making an innocent misrepresentation, discovers the truth yet thereafter silently allows another to rely on the misrepresentation is guilty of fraud" (Williston, Contracts, § 1497 at 381 (3d ed. 1970)).

(4) In January 1985, S&C and Swan obtained a Judgment from the Court. Upon Stipulations "So Ordered," the District Court made an Order Directing Entry of Final Judgment, which recited that 86 plaintiffs had settled.

(5) In March of 1986, S&C did not produce the documents to a different attorney and falsely stated in Open Court that it knew of no documents not

produced. As the District Court found (pp. 75a, 76a, infra):

> On February 12, 1986, the day of the Wall Street Journal article concerning the SEC action, Berger [attorney for a plaintiff ("Merana") who had not settled] called Hardiman and demanded production of all documents, a demand on which argument was heard on March 14, 1986. In March, Hardiman conducted a search of [S&C's] files, but did not locate the [relevant] documents.
>
> ...
>
> ... [S&C] thus did not produce any more documents than it had produced in Cresswell I.

Attorney Berger stated in Open Court that he had "discovered an egregious instance of withholding of

documents." Mr. Hardiman, thus accused by Affidavit and in Open Court, stated to the Court that he knew of no documents not produced. The District Court accepted Mr. Hardiman's claim and ruled that it would not sanction Bache for failure to produce. Mr. Hardiman made thorough searches for the relevant documents in S&C's files. But Sullivan & Cromwell claimed it could not find the documents now admitted to have been in its files.

(6) In July 1986, the concealment from Swan was repeated in a related federal action (the "Reitz action"). In finding sufficient evidence of fraudulent intent, the District Court further noted:

> In 1986, Swan also represented another plaintiff who had participated in the [marketed investment] and served the same document demand.

> On July 25, 1986, [S&C] responded that all documents had been produced although such was not the case. [pp. 76a-77a, infra]
>
> By this time [S&C] had obtained documents by subpoena of the Exchange .... Certainly the NYSE documents put [S&C] on notice that the earlier production in Cresswell I was inadequate. [p. 77a, fn. 5, infra]

(7) From May 1987 to February 1988, S&C concealed many of the same documents during discovery in the present case.

The District Court found (p. 76a, infra) that the relevant "file kept at Bache was not produced by [S&C] until February 1988 in this proceeding." More specifically: In 1987, S&C produced to the Cresswell II attorneys some of the missing documents. In 1988, Bache

produced the rest of the missing documents, together with evidence that all had been sent to S&C in 1983. Only then did S&C produce its hidden documents.

Upon review of the foregoing, the District Court found sufficient evidence of fraudulent intent to deny summary judgment. "There is a material question of fact ... as to whether intent can be inferred" (p. 99a, infra). "Schwartz's interpretation ... could raise an inference of intent to withhold documents fraudulently" (p. 100a, infra). "In addition, the inconsistency between the explanation of Schwartz and Hardiman ... raises an issue of fact as to whether there was a conscious decision to withhold on a basis other than that now urged by Schwartz" (id.). "Drawing all inferences on behalf of plaintiff, a question of fact exists as to whether [S&C] intended to defraud the plaintiffs ... by

withholding the July 11, 1984 Letter in hopes of achieving a settlement before the results of the inquiry became known, which is, of course, what happened" (p. 101a, infra). "In addition [other facts] all fortify the inference of intentional withholding" (p. 102a, infra).

Similarly as to materiality: "Once the reasonableness standard is introduced, it is difficult to deny that there is a factual issue as to the effect of an investigation by a regulatory body" (pp. 105a-106a, infra). "These settlements constitute objective evidence to support the inference that knowledge of the NYSE investigation was material" (p. 106a, infra). Various circumstances "all raise a factual issue as to whether or not the withheld information was material" (p. 108a, infra).

REASONS FOR GRANTING THE WRIT

A. A victim's lack of vigilance in detecting fraud, does not excuse fraud on the court.

Hazel-Atlas Glass Co. v. Hartford-Empire Co., 322 U.S. 238 (1944), established that diligence is not required in actions for fraud on the court, and is discussed in 7 J. Moore & J. Lucas, Moore's Federal Practice, ¶ 60.33 at 60-355 to 356:

> Hartford had defrauded the Patent Office by helping along its application for a patent through the use of an article written ... by certain of its attorneys and officials under the name of an ostensibly disinterested expert; and later in its action for patent infringement had defrauded the court of appeals

through use of the article. ... The Court stated [322 U.S. at 246]:

> The Circuit Court did not hold that Hartford's fraud fell short of that which prompts equitable intervention, but thought Hazel had not exercised proper diligence in uncovering the fraud and that this should stand in the way of its obtaining relief .... But even if Hazel did not exercise the highest degree of diligence, Hartford's fraud cannot be condoned for that reason alone. This matter does not concern only private parties .... Furthermore, tampering with the administration of justice ... involves far more than an injury to a single litigant. It is a wrong against the

> institutions set up to protect and safeguard the public, institutions in which fraud cannot complacently be tolerated consistently with the good order of society. Surely it cannot be that preservation of the integrity of the judicial process must always wait upon the diligence of litigants. The public welfare demands that the agencies of public justice be not so impotent that they must always be mute and helpless victims of deception and fraud.

Hazel-Atlas further held (322 U.S. at 249, fn. 5):

> [I]nsofar as a trial would serve to bring forth additional evidence showing that Hazel was not diligent in uncovering these facts, we

> already have pointed out that such evidence would not in this case change the result. [Emphasis added.]

The dissent in Hazel-Atlas unsuccessfully argued that the newly proffered evidence "must be such as could not have been discovered by the exercise of reasonable diligence" (id. at 260) and "could not have [been] ascertained by use of proper and reasonable diligence" (id. at 268).

Fed. R. Civ. P. 60(b) was enacted with Hazel-Atlas in mind. The 1946 Note of the Advisory Committee states:

> And the rule expressly does not limit the power of the court, when fraud has been perpetrated upon it, to give relief under the saving clause. As an illustration of this situation, see Hazel-Atlas ....

11 Wright & Miller, Federal Practice and Procedure, § 2870 at 249, states: "Almost all of the principles that govern a claim of fraud on the court are derivable from the Hazel-Atlas case." Further: "The court thought it immaterial that Hazel may not have exercised proper diligence in uncovering the fraud." Id.

In Averbach v. Rival Manufacturing Co., 809 F.2d 1016, 1021 (3rd Cir. 1987), the Court addressed fraud on the court, referring to Hazel-Atlas, "in which it was held that a court has inherent power to set aside a judgment obtained by such a fraud, even in circumstances where the adverse party might be barred by ... lack of diligence from obtaining relief."

In Kupferman v. Consolidated Research and Manufacturing Corporation, 459 F.2d 1072, 1078-79 (2d Cir. 1972), the Court, citing Hazel-Atlas, said that a

"negligent failure to discover" would not bar an independent action for fraud on the court.

Plainly, if fraud upon the court was, or may have been, practiced by attorneys at S&C, then the Court of Appeals should not have held that the plaintiffs "must show 'the absence of fault or negligence'" on their part (p. 10, supra). Fraud upon the court is a wrong which "cannot be complacently tolerated" (Hazel-Atlas); it should not be allowed to triumph over a "negligent failure to discover" (Kupferman).

B. Fraud by an attorney in conducting a case, is fraud upon the court.

7 Moore's Federal Practice, ¶ 60.33 at 60-357 to 359, asks:

> What type of fraud may be properly classed as a fraud upon the

court ...? The more obvious ... examples are: bribery or other corruption of the court .... But Hazel-Atlas goes much further. In this case the court was not corrupted; and the extent to which the concocted article influenced the court was problematic. But ... the fraud involved [in Hazel-Atlas] differs little from that in United States v. Throckmorton [98 U.S. 61 (1878)], which the Court held would not support an independent action. One point of difference, although not stressed by the court in Hazel-Atlas, is that an attorney of Hartford was implicated in perpetrating the fraud. We believe that this is important, for, while an attorney should represent his client with singular loyalty, that loyalty obviously does not demand

that he act dishonestly or fraudulently ....

In Kupferman, supra, the Second Circuit discussed the meaning of "fraud upon the court" (459 F.2d at 1078):

> Professor Moore submits that the concept should "embrace only that species of fraud which does or attempts to, defile the court itself, or is a fraud perpetrated by officers of the court so that the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases that are presented for adjudication." ... Professor Moore explains Hazel-Atlas ... largely on the basis ... that an attorney was implicated in perpetrating the fraud. "[An attorney's] loyalty to the court, as an officer thereof, demands integrity

and honest dealing with the court. And when he departs from that standard in the conduct of a case he perpetrates a fraud upon the court." [Emphasis added.]

Accord: H. K. Porter Company, Inc. v. The Goodyear Tire & Rubber Company, 536 F.2d 1115, 1119 (6th Cir. 1976) ("Since attorneys are officers of the court, their conduct if dishonest would constitute fraud on the court"); Virgin Islands Housing Authority v. David, 823 F.2d 764, 767 (3rd Cir. 1987) (quoting those words from Porter); In re Intermagnetics America, Inc., 926 F.2d 912, 916 (9th Cir. 1991) ("fraud upon the court includes both attempts to subvert the integrity of the court and fraud by an officer of the court", there a debtor-in-possession); Cleveland Demolition Company, Inc. v. Azcon Scrap Corporation, 827 F.2d 984, 986 (4th Cir. 1987) ("the

'involvement of an attorney, as an officer of the court, in a scheme to suborn perjury should certainly be considered fraud on the court'"); Rozier v. Ford Motor Company, 573 F.2d 1332, 1338 (5th Cir. 1978) ("the fabrication of evidence ... in which an attorney is implicated, will constitute a fraud on the court"); Matter of Wallace, 57 Bankr. 364, 365 (W.D.Mo. 1985) ("fraud upon the court ... includes the involvement of an attorney, as an officer of the court, in the perpetuating of fraud"); Procelli v. Joseph Schlitz Brewing Company, 78 F.R.D. 499, 500 (E.D.Wisc. 1978) ("courts have found fraud upon the court only where there is a showing of ... involvement of an attorney in perpetrating the fraud"); Lockwood v. Bowles, 46 F.R.D. 625, 631 (D.C.D.C. 1969) ("Examples [of fraud on the court] are ... involvement of an attorney in the perpetration of fraud"); Petry v. General

Motors Corporation, 62 F.R.D. 357, 361 (E.D.Pa. 1974) (quoting those words of Lockwood); In re Lawler, 50 Bankr. 110, 115 (N.D.Tex. 1985) (quoting the words of Rozier, supra this paragraph).

C. No exception exists for attorneys' frauds that are committed outside the Courtroom.

Is fraud on the court present if attorneys, in their conduct of four related federal cases (Cresswell I, Merana, Reitz and Cresswell II) over a period of years, repeatedly and fraudulently conceal material evidence? Here the concealment occurred primarily in the discovery phases of the cases; although on one occasion (p. 17, supra) the attorneys did make their misrepresentation in Open Court.

Attorneys conducting federal litigation are never separated from the Court;

they are its officers and must act as such throughout the conduct of a case. In In re Snyder, 472 U.S. 634, 644 (1985), this Court held:

> ... Justice Cardozo once observed:
>
> > "'Membership in the bar is a privilege burdened with conditions.' [An attorney is] received into that ancient fellowship for something more than private gain. He [becomes] an officer of the court, and, like the court itself, an instrument or agency to advance the ends of justice." People ex rel. Karlin v. Culkin, 248 N.Y. 465, 470-471 ... (1928) (citation omitted).

As an officer of the court, a member of the bar enjoys singular

> powers that others do not possess .... Admission creates a license not only to advise and counsel clients ...; as an officer of the court, a lawyer can cause persons to drop their private affairs and be called as witnesses ... for depositions and other pretrial processes that, while subject to the ultimate control of the court, may be conducted outside courtrooms. The license granted by the court requires members of the bar to conduct themselves in a manner compatible with the role of courts in the administration of justice. [Emphasis added.]

Other decisions holding that attorneys are "officers of the court" include Gentile v. State Bar of Nevada, 111 S.Ct. 2720, 115 L. Ed.2d 888, 1191 U.S. Lexis 3820 at 73, 76, 86 (1991); Nix v.

Whiteside, 475 U.S. 157, 174 (1986); Cohen v. Hurley, 366 U.S. 117, 126 (1961) (quoting People ex. rel. Karlin, supra, p. 32); Theard v. United States, 354 U.S. 278, 281 (1957) (same). In the present case, there was sufficient evidence that officers of the court defrauded other officers of the court year after year and on one occasion repeated the misrepresentation directly to the District Judge. That must constitute "fraud on the court," unless the role of attorneys is debased far below the standards of prior decades.

We turn now to the practicalities. In Gentile (supra, p. 33), this Court stated that the "attorneys role as advocates gives them 'extraordinary power to undermine or destroy the efficacy of the criminal justice system' ...." 1991 U.S. Lexis 3820 at 74 (citation omitted). Here, there was sufficient evidence that

officers of the court used their civil discovery powers to withhold material evidence so as to "undermine ... the efficacy" of the civil justice system.

Attorneys exercise similar powers, almost always properly, in every civil case. Discovery is a critical part of "the judicial process" and "the administration of justice" referred to in Hazel-Atlas. 4 Moore's Federal Practice, ¶ 26.02[1] at 26-59 to 60, quotes Hickman v. Taylor, 329 U.S. 495, 507 (1947):

> Mutual knowledge of all the relevant facts gathered by both parties is essential to proper litigation. To that end, either may compel the other to disgorge whatever facts he has in his possession. [Emphasis added.]

Fraudulently unequal discovery tilts the process in favor of those who cheat.

Where one party must "disgorge whatever facts he has in his possession," while the other fraudulently avoids that duty, an unfair settlement or trial is preordained. Attorneys are part of the "judicial machinery," and when they deceive opposing counsel, "the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases that are presented for adjudication." Kupferman, supra, quoting Moore's.

That fraud on the court by officers of the court is not limited to instances of misrepresentations made directly to a judge or jury, is also shown by the broad language of the Kupferman, Porter, Virgin Islands, Intermagnetics, Rozier, Wallace, Procelli, Lockwood, Petry and Lawler decisions quoted supra, pp. 29-31. For example, Porter: "Since attorneys are officers of the court, their conduct if dishonest would constitute fraud on the

court." The language employed by these Courts contains no suggestion that fraud on the court is limited to conduct committed in Open Court. Not until this case have attorneys been told that they may fraudulently withhold material evidence in federal discovery and then dance away from their frauds if they can show that opposing counsel were not sufficiently vigilant to catch them and that the fraudulent concealments were repeated only once in Open Court.

In Aoude v. Mobil Oil Corporation, 892 F.2d 1115 (1st Cir. 1989), the plaintiff had annexed a fraudulent paper to a complaint filed in State Court, from which the action was removed. The fraudulent paper was part of a "scheme which he [the plaintiff] masterminded and in which he and his attorney jointly participated." Id. at 1121. Plaintiff "and his counsel continued to act out the charade" in

discovery proceedings which finally "revealed a glimmer of the truth." Id. at 1118. "Even then, [plaintiff] hedged his bets, forcing [defendant] to piece together the sordid story bit by bit." Id.

Although none of the fraud took place in Open Court, and the case never went to trial, the First Circuit, citing (892 F.2d at 1119) Cleveland Demolition and Rozier, pp. 29-30, supra, held (id. at 1118):

> Because corrupt intent knows no stylistic boundaries, fraud on the court can take many forms. In our estimation, however, the present case is a near-classic example of the genre.

Subsequently, the Court referred to "those who ... practice unmitigated fraud upon the court itself" (892 F.2d at 1119). This is a clear First Circuit

holding that "fraud on the court" may occur outside the Courtroom.

In Petry, pp. 30-31, supra (E.D.Pa. 1974), plaintiff alleged that "the defendant ... falsely answered interrogatories put to them by the plaintiff, and that plaintiff's reliance on those answers was the basis for entering into the settlement agreement." 62 F.R.D. at 358. The Court found fraud on the court absent, but only because of the failure to allege "the involvement of an attorney (an officer of the court) in the perpetration of fraud." Id.

In Kupferman (p. 28, supra), the Second Circuit, citing Hazel-Atlas stated that a "negligent failure to discover" would not bar an action for fraud on the court if opposing counsel "had instituted ... an action to which he knew there was a complete defense." 459 F.2d at 1079.

The institution of an action does not occur in Open Court.

In Israel Aircraft Industries, Ltd. v. Standard Precision, 559 F.2d 203, 207 (2d Cir. 1977), the Court found attorneys not "guilty of fraud upon the court" but only because the nonproduction of documents demanded in discovery was simply due to attorneys' unintentional "misunderstandings, lack of communication and in some instances, carelessness."

* * *

We conclude that fraud by attorneys, year after year, primarily in the context of discovery, is fraud upon the court, because (1) attorneys are officers of the court; (2) discovery frequently determines the actual outcome of a case; (3) the broad language used by the Courts in addressing fraud by officers of the court, is not limited to frauds in Open

Court; and (4) the facts in Aoude, Petry, Kupferman and Israel Aircraft involved fraud or alleged fraud during discovery.

D. This case presents an important question and conflicting answers.

Until now, no court has ever clearly held that fraud by attorneys during discovery is not fraud on the court. But now, the District Court, upon remand, has held that the instant "fraud claim is not a claim for 'fraud on the court,'" infra, p. 20a, even though that same Court found that sufficient proof had been adduced of fraudulent intent and of materiality. The District Court's reasonable interpretation of the Court of Appeals 1990 decision herein, has now been affirmed by the Court of Appeals.

Kupferman (supra) and Gleason v. Jandrucko, 860 F.2d 556 (2d Cir. 1988),

which had warned that *if* attorneys conducted discovery fraudulently, that would constitute fraud on the court, have now been interpreted to mean that fraudulent discovery practices by attorneys are not fraud on the court (p. 23a, *infra*).

Accordingly, for the first time, it is now clear in the Second Circuit that protracted frauds during discovery *by attorneys* conducting the discovery, is not fraud on the court and the consequences for officers of the court who engage in such practices will be no different than for litigants who succumb to temptation.

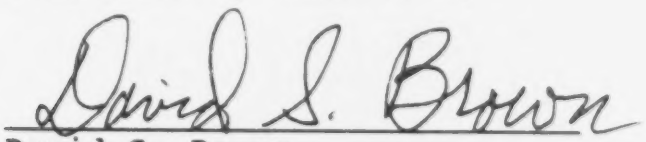
This conflicts with the decisions of this Court as to the role of attorneys and their ability to undermine or destroy the efficacy of litigation, and as to the critical nature of fair discovery. It conflicts with widely accepted interpretations of *Hazel-Atlas* and with

decisions such as Aoude which recognize that fraud on the court, when practiced by officers of the court, need not be limited to frauds in Open Court. The decision condones a dangerous repudiation of the obligations that attorneys owe to the Courts, to each other and to society.

CONCLUSION

For these various reasons, this Petition for Certiorari should be granted.

Respectfully submitted,



David S. Brown
Cooper, Brown & Behrle, P.C.
30 Rockefeller Plaza
New York, New York 10112
(212) 957-9000
Counsel of Record

May 25, 1992

A P P E N D I X

EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

- - - - - -

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 25th day of February one thousand nine hundred and ninety-two.

Present: HONORABLE ELLSWORTH A. VAN GRAAFEILAND,

HONORABLE AMALYA L. KEARSE,

HONORABLE J. DANIEL MAHONEY,

Circuit Judges,

EDWARD CRESSWELL, AGRICONSULTANTS INCORPORATED, AMERICAN GROWTH PROPERTIES MANAGEMENT COMPANY LTD., ERIC APPLETON, BERFORS FINANCE LTD., JOHN BIRD, NORA BIRD, PETER BURKHARDT, JOHN A. L. CHETTOE, DENNIS R. DUDENEY, V. S. DWIVEDI, LARS FEUK, FLETCHER INVESTMENTS LTD., JOHN H. FLETCHER, NOEL FOX, STUART J. GARDINER, F. GEORGE, KENNETH E. F. GEORGE, VERITY ANNE GIBBONS, POLLY GREGORY, A. D. HARRIS, DAVID G. HART, JOHN M. HAWKINS, PATRICIA HAWKINS, SPENCER HAYES, HILARY CORPORATION, INC., ANTHONY HYDE, IZRADA, S.A., GORDON WALTER JAMES, JOVAL INVESTMENTS, LTD., JAD KABBAN, ESTATE OF PHILIP J. KNIGHT, PIERRE LAMARCHE, ROGER LANDAU, ANDREW LEWIS, JAMES J. MATHER, MALCOLM MILTON, GREGOIRE MOZDYNIEWICZ, COLLIN DAVID PARKER, PEZCO OVERSEAS, INC., JOHN PIRIE, A. REMINI, JULIA A. ROBIN, ROGER Y.

ROBIN, CLAUDINE SEIKALY, JOHN B. SHAW, ROBERT W. SHIELDS, SIANPLAN LTD., REGINALD E. SILLETTO, BASILIA L. W. ABEL SMITH, DAVID F. SMITH, ALEC SNOBEL, GEOFFREY W. SUTCLIFFE, JAN WALLIN, PATRICIA WILKINSON, as Executrix, and GORDON WILSON,

Plaintiffs-Appellants,

- v. - Nos. 91-7800
-7804

SULLIVAN & CROMWELL,

Defendant-Appellee.

Appeals from the United States District Court for the Southern District of New York.

These causes came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and were argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgments of said District Court be and they hereby are affirmed.

Plaintiffs Edward Cresswell, et al., appeal from judgments of the United States District Court for the Southern District of New York, Robert W. Sweet, Judge, refusing to remand certain of their claims to state court and dismissing their complaints charging defendant Sullivan & Cromwell ("S&C") with fraudulent nondisclosure during discovery in a prior action in the same court by plaintiffs against S&C's client. On appeal, plaintiffs contend that the district court misinterpreted this Court's decision on the prior appeal in this matter, Cresswell v. Sullivan & Cromwell, 922 F.2d 60 (2d Cir. 1990) ("Cresswell I"), and argue, inter alia, that their claims for common-law fraud should have been remanded to state court, that they should be allowed to pursue a claim of fraud on the court, and that they should not be required to show lack of fault in

reliance on the alleged nondisclosures. For the reasons below, we affirm the judgment.

In Cresswell I, we noted that the district court had granted summary judgment against plaintiffs on the ground that their reliance, if any, on the alleged nondisclosures was not justifiable in light of the facts disclosed in the record. We stated that, considering the claim only as a matter of law, the district court did not err; but that since the court's equity jurisdiction had been invoked, the court should revisit its ruling within the framework of an action in equity. On remand, the court followed our direction, and it concluded that as a matter of equity plaintiffs could not prevail. We find no error in this ruling.

Many of plaintiffs' arguments on this

appeal are efforts to rehash arguments made in Cresswell I. We neither address nor consider them. In other respects, plaintiffs' arguments confuse various facets of federal jurisdiction and procedure. The fact that the court did not have diversity or federal questions jurisdiction to entertain the action did not mean that plaintiffs had failed to state a cause of action. Our ruling in Cresswell I that the court had neither of those more routine types of jurisdiction but did have ancillary equitable jurisdiction did not mean that we held, as plaintiffs repeatedly state, that their fraud claims were "beyond federal jurisdiction." Where, as here, the district court has jurisdiction over the action, it may exercise pendent jurisdiction over common-law claims between nondiverse parties. The exercise of pendent jurisdiction over common-law

fraud claims here was not an abuse of discretion. See, e.g., Carnegie-Mellon University v. Cohill, 484 U.S. 343, 350-51 (1988).

Nor is there merit in plaintiffs' contention that the district court was required to remand the newly commenced actions to state court. Though dependent on some other facet of the court's power, ancillary equitable jurisdiction is "original" jurisdiction, as that term is used in the removal statutes, when the suit is one that can properly be commenced in federal court. See, e.g., Oklahoma Tax Commission v. Graham, 489 U.S. 838, 840 (1989) (per curiam). An action over which the court has original jurisdiction may be removed by the defendant to federal court. 28 U.S.C. § 1441. Since, as we ruled in Cresswell I, a federal court has ancillary equitable jurisdiction to entertain an original

action based on alleged fraud in connection with the settlement of a prior action in the same court, removal was proper.

Finally, we affirm the district court's summary dismissal of the newly asserted claims under § 487 of the N.Y. Jud. Law, on the grounds that (a) the conduct attributed to S&C did not fit the pattern for a proper action under that section, see, e.g., Wiggin v. Gordon, 115 Misc. 2d 1071, 1077, 455 N.Y.S.2d 205, 209 (N.Y. Civ. Ct. 1982) ("[s]ection 487 of the Judiciary Law should be applied only to the chronic, extreme pattern of legal delinquency"), and (b) in light of the lack of diligence of Swan, see Cresswell I, 922 F.2d at 71, plaintiffs cannot prove causation.

We have considered all of plaintiffs' arguments on this appeal and have found

them to be without merit.

The judgments of the district court are affirmed.

Edward CRESSWELL, et al., Plaintiffs,

v.

SULLIVAN & CROMWELL and Prudential Bache Securities, Inc., Defendants.

Percy Herbert MEADOWS, et al., Plaintiffs,

v.

SULLIVAN & CROMWELL and Prudential Bache Securities, Inc., Defendants.

Edward CRESSWELL, et al., Plaintiffs,

v.

SULLIVAN & CROMWELL, Defendant.

Elizabeth E. NOBLE, et al., Plaintiffs,

v.

SULLIVAN & CROMWELL and Prudential Bache Securities, Inc., Defendants.

Nos. 87 Civ. 2685 (RWS), 88 Civ. 2221 (RWS), 91 Civ. 0333 (RWS) and 91 Civ. 0676 (RWS).

United States District Court, S.D. New York.

July 17, 1991.

As Amended July 25, 1991.

SWEET, District Judge.

In *Cresswell v. Sullivan & Cromwell*, 87 Civ. 2685 (RWS) ("*Cresswell II*"), defendant Sullivan & Cromwell ("S & C") has moved on remand for summary judgment dismissing the complaint of plaintiff Edward Cresswell ("Cresswell"). In *Meadows v. Sullivan & Cromwell*, 88 Civ. 2221 ("*Meadows*"), plaintiff Percy Herbert Meadows ("*Meadows*") has moved to stay all proceedings, and in *Cresswell v. Sullivan & Cromwell*, 91 Civ. 0333 ("*Cresswell III*"), and *Noble v. Sullivan & Cromwell*, 91 Civ. 0676 ("*Noble*") plaintiffs Cresswell and Elizabeth E. Noble ("Noble") have moved to remand their cases to the New York State Supreme Court. Cresswell has also moved to stay or dismiss *Cresswell II*. For the following reasons, S & C's motion is granted, the other motions are denied, and summary judgment is entered in S & C's favor on all of the complaints.[1]

BACKGROUND

The parties, underlying facts, and prior proceedings are fully described in the prior opinions of this Court and the Court of

1. For ease of reference, the term "Plaintiffs" will be used throughout this opinion to refer to those individuals who are plaintiffs in whichever of the four actions is relevant to the discussion. Also, *Cresswell II* and *Meadows* will be referred to as the "Old Actions" and *Cresswell III* and *Noble* will be called the "New Actions."

Appeals, familiarity with which is assumed. *Cresswell v. Sullivan & Cromwell*, 922 F.2d 60 (2d Cir.1990), *rev'g* 704 F.Supp. 392 (S.D.N.Y.1989).

In December 1990, the Second Circuit opinion reversed on jurisdictional grounds the grant of summary judgment in S & C's favor on the *Cresswell II* fraud claim and remanded it to this Court for consideration in light of the proper jurisdictional basis. Shortly thereafter, Cresswell and Noble instituted the *Cresswell III* and *Noble* actions in New York State Supreme Court, essentially repeating the allegations and claims for relief made in *Cresswell II* and in *Meadows*.

On January 15, 1991, S & C removed both of the new actions to this Court and at the same time moved for summary judgment dismissing *Cresswell II*. On February 19, Cresswell responded with his motion to remand *Cresswell III* and to stay or dismiss *Cresswell II*, and on February 20 Meadows and Noble filed moved to remand *Noble* and to stay *Meadows*. All of the motions were argued and fully submitted on March 29.

DISCUSSION

1. *There Is Jurisdiction Over the Cresswell II Fraud Claim.*

In seeking to differentiate the claim in *Cresswell II* from those in the New Actions, Plaintiffs assert that the Second Circuit impliedly dismissed their common law fraud claim against S & C and upheld federal jurisdiction only over their equitable claims. Arguing that they never intended to assert such claims and that as "masters of their complaints" they have the right to determine which claims they will press and which law will govern those claims, they seek dismissal of *Cresswell II* and permission to prosecute their common law claims in the only court which they believe has subject matter jurisdiction over those claims, namely the New York State court.

However, analysis of the Circuit Court's opinion indicates that it did not dismiss any of the Plaintiffs' claims and instead explicitly upheld this Court's jurisdiction to adjudicate them.

At the outset of its jurisdiction discussion, the Court of Appeals summarized its decision, stating

> [W]e conclude that there is neither diversity jurisdiction nor federal question jurisdiction under the provisions relied on by plaintiffs. We are persuaded, however, that the district court had ancillary equitable jurisdiction to entertain the action.

922 F.2d at 68. The court proceeded to

clarify that "plaintiffs' claim is that S & C committed common-law fraud." *Id.* at 69.

After dismissing diversity and federal question as the basis for jurisdiction, the court again stated

> Notwithstanding the absence of federal question jurisdiction and the apparent absence of diversity, however, we concluded for the reasons below that the court had ancillary equitable jurisdiction to entertain an attack on the *Cresswell I* judgment.

Id. at 70.

Following an explanation of the origins of this type of jurisdiction, the court, finding that "[a]ncillary jurisdiction is sufficiently flexible that the action may be maintained against a person who was not a party to the original action," *id.*, concluded that "the district court had ancillary equitable jurisdiction over the present claims against S & C." *Id.*

Thus, the Circuit Court held that this Court "had ... jurisdiction to entertain the action," an action in which "plaintiffs' claim is that S & C committed common-law fraud," which represented "an attack on the *Cresswell I* judgment." Far from dismissing any of the Plaintiffs' claims, the Court of Appeals explicitly held that there was jurisdiction over the Plaintiffs' "present claims." There is simply no support in the opinion for the Plaintiffs' con-

tention that in speaking of the "present claims against S & C" the Court of Appeals meant to refer to anything but the claims pled in the *Cresswell II* complaint. Therefore there is federal jurisdiction over the *Cresswell II* claims.

2. *In Holding That Equitable Standards Would Govern the Plaintiffs' Fraud Claim, the Court of Appeals Implied that the Claim Was Federal in Nature.*

Significantly, the Circuit Court did not merely hold that this Court would have had equitable ancillary jurisdiction if the Plaintiffs' had chosen to frame their fraud claim in equity, but rather determined that there was jurisdiction over the claim as it had been pled. Moreover, after expressly acknowledging that the claim was for common-law fraud, the Circuit Court stated that

> Considering this issue solely as a matter of law, we would concluded that the district court did not err in [finding no reliance as a matter of law.]
>
> As indicated ... above, however, *the present action is not an action at law, but is one addressed to the court's equity powers.*

Id. at 71. In other words, although recognizing that the Plaintiffs had pled their claim as a legal one, the Court of Appeals held that it actually sounded in equity.

Apparently, the Court of Appeals concluded that the Plaintiffs' claim, charging fraud in connection with the entry of judgment in *Cresswell II*, was a federal equitable claim disguised through the technique of artful pleading as a state common law claim. The technique of looking beyond the words of the complaint to discern the true nature of the plaintiffs' claim, typically referred to as the "federal character" doctrine, was approved by the Supreme Court in *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394, 397 n. 2, 101 S.Ct. 2424, 2427 n. 2, 69 L.Ed.2d 103 (1981). There the Court held that the district court had properly granted removal where the plaintiffs' claims, although framed solely as state law claims, "had a sufficient federal character to support removal." The Court justified this disregard of the plaintiffs' choice of claims as follows:

> [C]ourts "will not permit plaintiff to use artful pleading to close off defendant's right to a federal forum ... [and] occasionally the removal court will seek to determine whether the real nature of the claim is federal, regardless of plaintiffs' characterization."

Id. (quoting 14 C. Wright, A. Miller & E. Cooper, Federal Practice and Procedure § 3722, pp. 564–66) (1966) (ellipsis and brackets in quoted material added in *Federated*).

The Second Circuit has acknowledged that under *Federated* a plaintiffs' control over its complaint must be tempered by the fact that it may not evade removal simply by pleading a federal claim in non-federal terms.

> [I]t is well-settled that a plaintiff as "master of the complaint" may preclude removal by electing to disregard an available federal dimension of a claim and asserting only a distinct state law cause of action. A corollary to these principles, however, is that a plaintiff cannot avoid removal by artful pleading, *i.e.*, by framing in terms of state law a complaint the "real nature of [which] is federal regardless of plaintiffs' characterization."

Derrico v. Sheehan Emergency Hospital, 844 F.2d 22, 27 (2d Cir.1988) (quoting *Travelers Indemnity Co. v. Sarkisian*, 794 F.2d 754, 758 (2d Cir.), *cert. denied*, 479 U.S. 885, 107 S.Ct. 277, 93 L.Ed.2d 253 (1986)) (citations omitted, brackets in *Derrico*); *accord Nordlicht v. New York Telephone Co.*, 799 F.2d 859, 862 (2d Cir.1986).

In *Travelers Indemnity*, the Court of Appeals articulated a two-part test to determine whether a claim ought to be considered as federal in nature. First, there should be "substantial identity between the elements of the state and federal claim." 794 F.2d at 760. Where that threshold

requirement was satisfied, "the second criterion that rendered [plaintiff's] claim 'federal' [was] the fact that he had previously elected to proceed in federal court." *Id.*

Applying this test to the Plaintiffs' claims here, the Second Circuit's decision clearly implies that the court found the requisite "substantial identity" between the common law fraud claim which the Plaintiffs had pled and their implied federal equitable claim. As for the second prong of the test, the Plaintiffs had repeatedly sought to have their case adjudicated in the federal forum, insisting that federal jurisdiction existed over the claim both in their complaint and even after the Second Circuit raised the issue *sua sponte*. Plaintiffs even offered to drop the claims of three parties in order to preserve diversity jurisdiction. *See Cresswell II*, 922 F.2d at 69. Thus the *Travelers Indemnity* test is satisfied and Plaintiffs' claim must be held to be of federal character.

Therefore, under the governing authority of the Supreme Court and the Second Circuit, the Court of Appeals' treatment of the Plaintiffs' appeal indicates that the *Cresswell II* fraud claim is in reality a federal equitable claim disguised as a state common law claim.

3. The Claims in the Other Three Actions Are Also "Federal in Nature."

Because the complaint in *Meadows* is virtually identical to the *Cresswell II* complaint, the conclusion that the *Cresswell II* fraud claim falls within the *Federated* "federal character" exception to the "master of the complaint" doctrine applies to the *Meadows* fraud claim as well.

As for the New Actions, which are themselves nearly identical, they each contain two fraud claims, one for "Fraud in Connection with the Exchange Inquiry" and a second for "Fraud in Connection with the Exchange Investigation." Both complaints also include a claim for relief under § 487 of the New York Judiciary Law[2]—the same claim which the Plaintiffs were prevented from adding in *Cresswell II* by this Court's denial of leave to amend, 704 F.Supp. at 411–12, a ruling which was affirmed on appeal. 922 F.2d at 72.

Comparison of the *Cresswell II* and *Cresswell III* complaints leads to the conclusion that the fraud claims alleged in the newer action are not meaningfully different from the fraud claim in the older case.

2. **Misconduct by attorneys**

An attorney or counselor who:

1. Is guilty of any deceit or collusion, or consents to any deceit or collusion, with intent to deceive the court or any party; ....

Is guilty of a misdemeanor, and in addition to the punishment prescribed therefor by the penal law, he forfeits to the party injured treble damages, to be recovered in a civil action.

While the original claim has been split into two separate claims, the allegations of both claims, when combined, virtually repeat the allegations in *Cresswell II*. Therefore, the preceding discussion compels the conclusion that the *Cresswell III* and *Noble* fraud claims are also federal in nature.

4. The Motions to Remand.

Given the foregoing analysis, the removal of the New Actions was proper and the motions to remand *Cresswell III* and *Noble* must be denied. Although the § 487 claim in each action is clearly a state law claim, the Plaintiffs' decision to join those claims with their fraud claims justifies removal of both of the New Actions in their entirety under 28 U.S.C. § 1441(c). While this approach effectively permits Plaintiffs to circumvent the denial of their original motion to amend in *Cresswell II*, it seems to present the best hope of resolving this litigation with any semblance of judicial efficiency.[3] *See also Valerio v. Boise Cascade Corp.*, 645 F.2d 699 (9th Cir.) (federal court properly asserted pendent jurisdiction over state law claims asserted together with federal equitable claim for fraud in earlier settlement), *cert. denied*, 454 U.S. 1126, 102 S.Ct. 976, 71 L.Ed.2d 113 (1981).

3. In addition, S & C has never asserted that this Court should decline jurisdiction over the § 487 claims in the New Actions.

Because the motions to remand are denied, it is not necessary to address the motions to stay or to dismiss *Cresswell II* and to stay *Meadows* pending resolution of the New Actions. Because the fraud claims in all four actions are the same and all are properly presented in this Court, resolution of one will effectively dispose of all.

5. The Motion for Summary Judgment.

a. The fraud claim is not a claim for "fraud on the court."

According to the Plaintiffs, summary judgment on the equitable fraud claim in *Cresswell II* is not warranted because reliance is not an element of an equitable claim for "fraud on the court" as defined by the Supreme Court in *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 64 S.Ct. 997, 88 L.Ed. 1250 (1944). Plaintiffs argue that because this Court previously found a genuine issue of fact as to S & C's intent and as to the materiality of the non-disclosures, S & C is not entitled to summary judgment on the equitable fraud claim.

The major obstacle which the Plaintiffs must overcome in making this argument is the Court of Appeals' discussion of the proper standard to be applied to their claim on remand.

> [I]n order to pursue an independent action to set aside a judgment, a plaintiff must show a recognized ground, such as fraud ..., for equitable relief and that there is no other available or adequate remedy. *It must also appear that the situation in which the party seeking relief finds himself is not due to his own fault, neglect or carelessness.* In this type of action, it is fundamental that equity will not grant relief if the complaining party "has, or by exercising proper diligence would have had, an adequate remedy at law, or by proceedings in the original action ... to open vacate, modify, or otherwise obtain relief against, the judgment." The granting of relief in this unusual type of proceeding lies largely within the discretion of the trial judge.

Cresswell II, 922 F.2d at 71 (quoting *Winfield Associates, Inc. v. Stonecipher*, 429 F.2d 1087, 1090 (10th Cir.1970)) (emphasis in *Cresswell II*). The Circuit Court further commented

> Most important for purposes of the present cases is the principle that in order to obtain the requested equitable relief a plaintiff must show "the absence of fault or negligence" on his own part.

Id. (quoting *Bankers Mortgage Co. v. United States*, 423 F.2d 73, 79 (5th Cir.), *cert. denied*, 399 U.S. 927, 90 S.Ct. 2242, 26 L.Ed.2d 793 (1970)).

The Plaintiffs contend that the Court of Appeals erred in this respect, arguing that it overlooked the controlling precedent of *Hazel-Atlas Glass*. They support this argument by pointing out that the entire jurisdictional issue was raised by the court *sua sponte* during oral argument and briefed only summarily by the parties after argument, with no attention to the standards which would govern if an alternate jurisdictional basis was found. They therefore assert that the court's enunciation of the standards to govern on remand must be viewed as dicta and should not control this Court's decision on remand.

S & C responds that the Plaintiffs' fraud claim does not rise to the level of fraud on the court, and that therefore the standard set forth by the Court of Appeals is appropriate, and Plaintiffs must show that they were not responsible for the harm which befell them. Moreover, S & C asserts that even if the Court of Appeals' opinion was clearly erroneous the law of the case doctrine would require this Court to follow that decision.

The essence of a claim of fraud on the court is a purposeful effort "which seriously affects the integrity of the normal process of adjudication." *Gleason v. Jandrucko*, 860 F.2d 556, 559 (2d Cir.1988) (citing *Kupferman v. Consolidated Research and Mfg. Corp.*, 459 F.2d 1072, 1078 (2d Cir.1972) and 7 Moore's Federal Prac-

tice ¶ 60.33, at 360). While Plaintiffs rely on *Kupferman* to support their argument that their claim alleges fraud on the court, the court in that case specifically declined to hold that an attorney's failure to disclose relevant information necessarily constituted such fraud: "it would be going to far to characterize as 'fraud upon the court' [the attorney's] failure to disclose an instrument which he could have supposed reasonable—although, as it now appears, erroneously—to have been known to his adversary." *Kupferman*, 459 F.2d at 1081.

Similarly, in *Gleason* the court was faced with a challenge to a prior settlement in which the plaintiff asserted that several witnesses had lied in their depositions in the earlier action. In declining to classify this behavior as fraud on the court, the court commented

> Gleason cannot be heard now to complain that he was denied the opportunity to uncover the alleged fraud. While the officers may have lied at their depositions, nothing prevented plaintiff during the pendency of the prior proceedings from deposing the two eyewitnesses to the bank robbery in order to impeach the officers' testimony. Instead, however, Gleason voluntarily chose to settle the action.

860 F.2d at 559.

Likewise, in *Martina Theatre Corp. v.*

Schine Chain Theatres, Inc., 278 F.2d 798 (2d Cir.1960), another case upon which Plaintiffs rely, the court distinguished the situation presented in that case from that in *Hazel-Atlas Glass*, stating

> When the parties moved for a dismissal of the [earlier action] with prejudice pursuant to stipulation, the district court had no duty to ascertain whether the settlement conformed with the antitrust laws ...; it sufficed for the court to know the parties had decided to settle without inquiring why.

Id. at 801.

Therefore, the Court of Appeals' decision not to view the Plaintiffs' equitable fraud claim as one for fraud on the court is more than amply supported by the relevant legal precedent.

Moreover, even were this not the case the standard announced by the Second Circuit would govern. Where an issue has been resolved upon appeal, on remand a lower court must adhere to that resolution under the doctrine of the law of the case. "[T]he lower court has no discretion to disregard that duty." *Soto-Lopez v. New York City Civil Service Union*, 840 F.2d 162, 167 (2d Cir.1988). Even if the prior decision were clearly erroneous, it would be up to the appellate court to correct its error.

> [The lower court] cannot vary [the higher

court's ruling], or examine it for any other purpose than execution; or give any other or further relief; or review it, even for apparent error, upon any matter decided upon appeal....

In re Sanford Fork & Tool Co., 160 U.S. 247, 255, 16 S.Ct. 291, 293, 40 L.Ed. 414 (1895). Therefore, as the Court of Appeals obviously intended to define the standard which would govern the remand, that definition could not be refused even if it were clearly incorrect.

b. The Plaintiffs have not shown that they are entitled to equitable relief.

The Court of Appeals' decision quite explicitly places the burden upon the Plaintiffs to show the absence of negligence on their part. 922 F.2d at 71. On the present motion, the Plaintiffs have not met this burden. Having devoted virtually their entire argument to the question of whether the claim should be viewed as one for fraud on the court, the sole evidence which they present to support their claim of no negligence consists of yet another declaration from Edward Swan ("Swan"), the Plaintiffs' original attorney in the underlying litigation, who merely re-emphasizes that he believed what he had been told by S & C, even when he was presented with information which might have contradicted those representations. Nothing in the new declaration is sufficient to overcome the conclusions which this Court drew in the

original grant of summary judgment that Swan had adequate knowledge and opportunity to uncover any wrongdoing on S & C's part, and that his failure to do so constitutes a basis for denying Plaintiffs their requested relief.

Therefore, as the Plaintiffs have failed to establish a factual issue as to their own attorney's diligence and the absence of neglect in uncovering the alleged fraud, summary judgment dismissing the fraud claim in *Cresswell II* is warranted. Because the fraud claims in the other three actions are indistinguishable from that in *Cresswell II*, those claims will be dismissed as well.

c. Summary judgment is appropriate on the § 487 claims.

Although S & C's original motion for summary judgment did not address the § 487 claims which are part of both of the New Actions, in their briefs on the present motions they have requested judgment on these claims, arguing that the claims are untimely. Because the facts already in the record and based on the prior rulings in this Court and on appeal summary judgment is granted on the § 487 claims.

S & C contends that the limitations period applicable to § 487 claims is either the three year period specified in § 214(2) of the N.Y.C.P.L.R., which covers "an action to recover upon a liability, penalty or

forfeiture created or imposed by statute" or the one year period of § 215(4) for "an action to enforce a penalty or forfeiture created by statute and given wholly or partly to any person who will prosecute." Under either provision, the Plaintiffs' claim, which accrued no later than 1985 when the *Cresswell I* lawsuit was settled, would appear to be barred. While it is not clear on the present record whether there might be grounds for tolling the limitations period, the prior ruling that the Plaintiffs' 1988 attempt to add the § 487 claim to their complaint in *Cresswell II* was untimely in light of the inexcusable delay and prejudice to S & C raises a strong possibility that any attempt to toll the statute would be offset by the Plaintiffs' laches. *Cf. G.D. Searle & Co. v. Cohn*, 455 U.S. 404, 411, 102 S.Ct. 1137, 1143, 71 L.Ed.2d 250 (1982) (discussing New Jersey approach to offsetting tolling and laches provisions).

Moreover, an element of a claim under § 487 is that the attorney's deceit must have caused the plaintiff's damages. In light of this Court's prior ruling that as a matter of law the Plaintiffs could not show that their damages were traceable to the alleged fraud of S & C rather than the negligence of Swan—a ruling which was expressly approved by the Second Circuit, 922 F.2d at 71—the Plaintiffs will not be

able to satisfy this element.[4]

Therefore, because there are ample grounds in the present record upon which the § 487 claims should be dismissed, summary judgment will be granted on these claims as well. Because the Plaintiffs have not been given an opportunity to contest this issue, leave will be granted to submit within twenty days of the date of this opinion any facts or authorities in relation to the propriety of this grant of summary judgment.

CONCLUSION

For all of the foregoing reasons, the various motions of the Plaintiffs in each of these four actions are denied, the summary judgment motion by S & C in *Cresswell II* is granted, and on that basis the complaint in *Cresswell III* is dismissed and the claims against S & C in the other three cases are dismissed.

It is so ordered.

4. As a final note on the § 487 claims, it has been said that this provision "is reserved for instances of attorney misconduct amounting to a 'chronic and extreme pattern of legal delinquency.'" *Brignoli v. Balch, Hardy & Scheinman, Inc.*, 126 F.R.D. 462, 467 (S.D.N.Y.1989) (quoting *Wiggin v. Gordon*, 115 Misc.2d 1071, 455 N.Y.S.2d 205 (N.Y.Civ.Ct.1982)). Nothing in the voluminous record amassed in this case would appear to support a finding that S & C's behavior amounted to such a pattern.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 721—August Term, 1989

(Argued: January 29, 1990
Final briefs submitted February 7, 1990
Decided: December 10, 1990)

Docket No. 89-7914

EDWARD CRESSWELL, AGRICONSULTANTS INCORPORATED, AMERICAN GROWTH PROPERTIES MANAGEMENT COMPANY LTD., ERIC APPLETON, BEFORS FINANCE LTD., JOHN BIRD, NORA BIRD, PETER BURKHARDT, PETER BYK, JOHN A.L. CHETTOE, DAVID E. COPE, DENNIS R. DUDENEY, V.S. DWIVEDI, LARS FEUK, FLETCHER INVESTMENTS LTD., JOHN H. FLETCHER, NOEL FOX, STUART J. GARDINER, C.L. GAVZEY, F. GEORGE, KENNETH E.F. GEORGE, VERITY ANNE GIBBONS, ROBERT GRANT, POLLY GREGORY, A.D. HARRIS, DAVID G. HART, JOHN M. HAWKINS, PATRICIA HAWKINS, SPENCER HAYES, HILARY CORPORATION, INC., ANTHONY HYDE, IZRADA, S.A., GORDON WALTER JAMES, JOVAL INVESTMENTS LTD., JAD KABBAN, PHILIP J. KNIGHT, PIERRE LAMARCHE, ROGER LANDAU, ANDREW LEWIS, HORACE G. LOVEGROVE, JAMES J. MATHER, MALCOLM MILTON, GREGOIRE MOZDYNIEWICZ, COLLIN DAVID PARKER, PEZCO OVERSEAS, INC., JOHN PIRIE,

MATTHEW H. PRIDGEON, A. REMINI, JULIA A. ROBIN, ROGER Y. ROBIN, CLAUDINE SEIKALY, JOHN B. SHAW, ROBERT W. SHIELDS, SIANPLAN LTD., REGINALD E. SILLETTO, BASILLA L.W. ABEL SMITH, DAVID F. SMITH, ALEC SNOBEL, GEOFFREY W. SUTCLIFFE, R.L. THOMAS, MARY C. WALLACE, JAN WALLIN, PATRICIA WILKINSON, as Executrix, and GORD N. WILSON,

Plaintiffs-Appellants,

DAMER HARRISSON, S.A.,

Plaintiff.

—v.—

SULLIVAN & CROMWELL and
PRUDENTIAL-BACHE SECURITIES, INC.

Defendants-Appellees.

Before:

OAKES, *Chief Judge,*
KEARSE and FLETCHER*, *Circuit Judges.*

Appeal from a judgment of the United States District Court for the Southern District of New York, Robert W. Sweet, *Judge*, dismissing complaint against defendant Sullivan & Cromwell for nondisclosures during dis-

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* Honorable Betty B. Fletcher, United States Court of Appeals for the Ninth Circuit, sitting by designation.

covery in prior case and disqualifying plaintiffs' former attorney from representing plaintiffs herein.

Affirmed in part, vacated and remanded in part.

RICHARD B. COOPER, New York, New York (James M. Latimer, Cooper, Brown & Behrle, P.C., New York, New York, on the brief), *for Plaintiffs-Appellants.*

BERNARD W. NUSSBAUM, New York, New York, (Kenneth B. Forrest, Jeffrey I. Lang, Wachtell, Lipton, Rosen & Katz, on the brief), *for Defendant-Appellee.*

KEARSE, *Circuit Judge*:

Plaintiffs Edward Cresswell, *et al.*, appeal from a final judgment of the United States District Court for the Southern District of New York, Robert W. Sweet, *Judge*, principally (1) dismissing so much of their second amended complaint as charged defendant Sullivan & Cromwell ("S&C") with fraudulent nondisclosure during discovery in a prior action by plaintiffs against S&C's client, defendant Prudential-Bache Securities, Inc. ("Bache"), and (2) voiding agreements relating to plaintiffs' representation in the present action by their former attorney. The district court granted summary judgment dismissing the complaint against S&C on the ground that plaintiffs could not show justifiable reliance on the challenged nondisclosure; it barred plaintiffs'

former attorney from representing them and receiving a contingent fee in the present action because he would be an essential witness at trial. On appeal, plaintiffs contend principally that summary judgment was inappropriate because the question of whether their reliance was justifiable raised a genuine issue of material fact; and they contend that the orders with regard to their former attorney should be set aside. For the reasons below, we vacate the judgment dismissing the claims against S&C and remand for further consideration by the district court.

I. BACKGROUND

This case has its roots in Bache's 1981-1982 offering in Europe of certain financial instruments (the "Spreads") based on the price differential between two types of futures contracts. Many of the facts are undisputed.

In October 1982, this price differential widened beyond its historical norms and caused holders of the Spreads, who included the present plaintiffs, to liquidate them at a loss. In March 1983, plaintiffs and several others brought suit against Bache in the district court for the Southern District of New York ("*Cresswell I*"), alleging that Bache had engaged in materially false and misleading marketing practices in connection with the Spreads. *Cresswell I* was settled by the present plaintiffs and Bache in early 1985 for approximately $3 million, enabling each of these plaintiffs to recover some 46% of his losses. Two other groups settled with Bache in July 1986 and January 1987, recovering some 94% and 71% percent of their respective losses.

The present suit was commenced in April 1987 against both Bache and S&C, asserting principally that during discovery in *Cresswell I*, Bache and S&C had fraudulently failed to produce certain documents that, if disclosed, would have led to a substantially higher settlement recovery for the present plaintiffs. The documents related to stock exchange inquiries into Bache's marketing of the Spreads.

A. *The New York Stock Exchange Investigation*

In January 1983, Polly Gregory, an investor who had suffered losses when she liquidated her Spreads and who would later become a plaintiff in *Cresswell I*, wrote to the New York Stock Exchange ("NYSE" or "Exchange"), complaining that the information provided her by Bache with respect to the Spreads had been misleading. Gregory's letter was routed to Barbara Krupinski in NYSE's Division of Member Firm Regulatory Services ("Services Division"), which handled customer complaints about member firms. Krupinski forwarded a copy to William Goldenblum, a Paris-based Bache attorney. Goldenblum responded to Krupinski by letter dated March 28, 1983, stating that Gregory had signed, *inter alia*, a "risk disclosure statement" and that Bache's marketing pamphlets were not misleading.

Krupinski responded to Gregory by letter dated April 29, 1983, stating that the Exchange had been in contact with Bache concerning her complaint, and sent her a copy of the March 28 letter the Exchange had received from Goldenblum. Krupinski's letter advised Gregory that the "Exchange staff does not adjudicate monetary claims or pass upon the merits of them," and suggested

that Gregory might wish to consider requesting arbitration. The letter concluded as follows:

> As part of our regulatory responsibilities, the staff of he [*sic*] Exchange examines all customer complaints to determine whether a firm or its representatives committed any violations of Exchange rules or ethical business practices. However, findings of any violations are made only after a full investigation and an administrative hearing before an Exchange hearing panel. Any disciplinary actions taken are made public only through the news media.

Communications between the Exchange and Goldenblum continued during the spring of 1983 and included, *inter alia*, a request by Krupinski for information concerning a 1981 advertisement for the Spreads.

In the meantime, other disgruntled Spreads investors, represented by Edward Swan, Esq., had commenced *Cresswell I* in March 1983. Bache was represented by S&C, which assigned attorneys Marvin Schwartz, a partner, and Howard Burnett and John L. Hardiman, associates, to handle the matter. On June 6, 1983, Bache's Goldenblum informed Hardiman of NYSE's interest in the 1981 advertisement and forwarded to Hardiman copies of Bache's correspondence with NYSE in connection with Gregory's complaint. Bache in-house attorney Barbara Salmanson, after consulting with Schwartz, prepared a response to NYSE's request for information. She sent the response to Krupinski at NYSE on June 8 and sent a copy to Hardiman.

In August 1983, NYSE's Services Division referred the matter of the Bache Spreads to the Exchange's Division

of Enforcement ("Enforcement"). On December 5, 1983, Donald E. Shippy, a Senior Enforcement Investigator, wrote Bache General Counsel Loren Schechter, indicating that Enforcement was investigating possible violations by Bache of NYSE's advertising standards. On December 9, Schechter responded that he would look into the matter. In the spring of 1984, there was further correspondence between Bache and Enforcement, and on July 11, 1984, Salmanson wrote Shippy describing the brochure promoting the Spreads and other documents, and stating that investors had been fully informed of the risks involved. A copy of the July 11 letter was sent to Burnett at S&C, who forwarded copies to Hardiman and Schwartz.

In August 1985, a settlement was reached between NYSE and Bache whereby, without admitting or denying guilt, Bache consented to a censure and a $5,000 fine. Based on this settlement, NYSE issued a decision in October stating that Bache had failed to disclose sufficiently the risks associated with the Spreads. The settlement was reported in the *Wall Street Journal* on February 12, 1986.

B. *The Pretrial Discovery and Settlements in* Cresswell I

By the time of the NYSE settlement and decision, most of the plaintiffs in *Cresswell I* had settled their suit. Prior to settlement, they had sought discovery concerning, *inter alia*, any stock exchange inquiries or investigations into the Bache Spreads.

Promptly after filing the *Cresswell I* complaint in March 1983, Swan made a request to Bache for the production of documents. In response, Bache produced more than 2,600 pages of documents in November 1983,

including documents indicating that the Chicago Board of Trade ("CBOT") and the London Department of Trade ("LDOT") were investigating Bache's marketing of the Spreads. In December 1983, Swan served on S&C a second request for Bache documents demanding, *inter alia*,

> [a]ny and all documents relating to any investigation or inquiry by any exchange, regulatory agency, or governmental body (whether in the United States or abroad) relating to defendant's marketing of the GNMA/T-Bond Spread which is the subject of this action.

This request was forwarded by Hardiman to Goldenblum at Bache, and though additional documents were produced, including some related to the CBOT and LDOT investigations, no documents relating to NYSE inquiries were produced.

On December 7, 1983, Gregory wrote to Swan, seeking to join the plaintiffs in *Cresswell I*. Gregory informed Swan in her letter that she had lodged a complaint with NYSE with regard to Bache's promotion of the Spreads. Gregory promptly became a plaintiff in *Cresswell I* and gave Swan some of the correspondence relating to her complaint to NYSE.

In June 1984, S&C's Burnett conducted Gregory's deposition; Gregory was represented at the deposition by Swan. Burnett marked as exhibits four documents relating to Gregory's complaint to NYSE, and identified some of them as having come not from Gregory, but from the files of Bache. Swan did not comment on the fact that these Bache documents had not been produced in response to plaintiffs' document demands, and he did

not make any follow-up inquiry of S&C. Nor did he contact NYSE to ascertain whether it had undertaken any investigation as a result of Gregory's complaint.

At the deposition, Swan asked Gregory to provide him with her copies of the Bache documents and of any other correspondence she had had with NYSE, and S&C requested copies. No such copies were produced until September 1984, after S&C moved to compel their production.

The parties in *Cresswell I* began settlement negotiations in the summer of 1984. In November 1984, Swan and Schwartz agreed on a figure of approximately $3 million, which would have allowed each plaintiff to recoup 46% of the losses suffered. Swan met with most of the plaintiffs to discuss the proposal and thereafter sent all plaintiffs a 10-page letter recommending the settlement. By February 1985, all but two of the plaintiffs had agreed to accept the settlement, and a judgment was entered pursuant to Fed. R. Civ. P. 54(b), dismissing the complaint as to the settling plaintiffs with prejudice. One of the two remaining plaintiffs went to trial on his claims in November 1987; the other, Merana, Ltd. ("Merana"), as discussed below, entered into a separate settlement in July 1986.

The *Wall Street Journal* article reporting the NYSE's settlement with and fining of Bache appeared in February 1986. An attorney for Merana promptly informed S&C's Hardiman of the article, and Hardiman asked Bache in-house attorney Salmanson whether the article referred to the Spreads that had been at issue in *Cresswell I*. Salmanson confirmed that it did and apologized for perhaps not having kept S&C informed of Enforcement's action. She immediately sent Hardiman

copies of all of the documents relating to the matter described in the article, again apologizing, and copies of the documents were then forwarded to Swan and to Merana's attorney. In July 1986, Merana settled with Bache for $300,000 plus legal fees, which represented 93.99% of its claimed losses. In January 1987, the plaintiffs in another action arising out of the Spreads also settled with Bache; they recovered 71% of their losses.

D. *The Present Action*

In April 1986, Swan wrote to the *Cresswell I* plaintiffs who had settled, informing them of the report of Enforcement's investigation. He stated that Bache's earlier nonproduction of the documents could constitute grounds for an additional monetary recovery, and he offered to negotiate a further settlement in return for 25% of any additional amount recovered; he stated, however, that if further litigation were required, "other arrangements will have to be made." Swan then met with Schwartz and Hardiman and stated that the failure to produce the documents had adversely affected the amount of the original settlement; he advised them that unless the payment to his clients were increased, he would bring a new suit. Schwartz rejected Swan's request for an additional settlement payment.

In April 1987, plaintiffs, now represented principally by Cooper, Brown & Behrle, P.C. ("Cooper-Brown"), commenced the present action against Bache and S&C ("*Cresswell II*"), alleging that in failing to produce the documents pertaining to the Enforcement investigation and the Services Division inquiry, Bache and S&C had committed fraud or had been grossly negligent, and that nonproduction had led plaintiffs to accept an artificially

low settlement. In connection with these allegations, depositions of, *inter alios*, Schwartz, Hardiman, and Swan were taken.

Hardiman and Schwartz testified that they had not been contemporaneously informed by Bache of the communications from the Enforcement division and were not aware of Enforcement's actions until the *Wall Street Journal*'s report in early 1986 of the censure and fine. Schwartz stated that Bache's Schechter had told him that Bache would handle any investigations by exchanges in-house, without S&C's help. Schwartz testified that he had viewed those NYSE communications of which he was aware, *i.e.*, the Services Division's responses to Gregory's complaint, as not amounting to an "investigation or inquiry," and he therefore believed the correspondence arising out of that complaint was not called for by the discovery request.

Swan, in his deposition, testified that he had served plaintiffs' second document demand, calling specifically for documents relating to regulatory body investigations, because he had noticed among the documents produced in response to the first request those relating to CBOT and LDOT investigations. Swan did not, however, recall making any inquiry of CBOT or LDOT with regard to their investigations of Bache. Nor did he make any inquiry of the Securities Exchange Commission, the National Association of Securities Dealers, or the Commodities Futures Trading Commission as to whether they were investigating Bache's marketing of the Spreads. Swan also testified that when S&C produced Goldenblum's March 28, 1983 letter to NYSE at Gregory's deposition, he viewed it as responsive to the second request for documents; but he testified that he

thought the nonproduction had been inadvertent, and therefore he did not ask S&C why the document had not been produced in response to that request. He also did not ask whether there were any other related documents that had not been produced. Nor did he make any inquiry of NYSE. Swan's 10-page letter to the *Cresswell I* plaintiffs in December 1984, recommending settlement, had not suggested as a factor favoring settlement either that no regulatory bodies were investigating or that regulatory bodies had investigated and had taken no action as a result. Swan had never discussed the activities of any regulatory body with his associate who worked on *Cresswell I*.

In July 1988, S&C moved for summary judgment dismissing the claims against it on the grounds that plaintiffs could not show intent, materiality, or justifiable reliance. S&C argued that plaintiffs could not show fraudulent intent because S&C (a) had had no knowledge prior to producing documents in response to the second request that there had been any inquiry from Enforcement, (b) had played no role in the Enforcement investigation of Bache, (c) had had no knowledge of the NYSE settlement until many months after the *Cresswell I* settlement was concluded, and (d) had marked documents relating to the Enforcement investigation at the Gregory deposition at which Swan had been present. S&C also argued that its nondisclosure was not material, pointing to, *inter alia*, deposition testimony by Krupinski that it was "rare" for customer complaints received by the Services Division to lead to disciplinary action, and that only 5% of the complaints she handled even reached the stage of a recommendation to her supervisor that the matter be referred to Enforcement for investigation. Shippy, who handled the investigation

for Enforcement, testified that his investigation had "nothing to do with the individuals who were suing the firm." Finally, emphasizing (a) Swan's failure to inquire of S&C or NYSE after receiving the documents from Gregory in January 1984 and even after seeing the documents from Bache's files at the deposition in June 1984, (b) Swan's failure to inquire of any other regulatory body with regard to investigations revealed in the documents produced, (c) the failure of Swan's letter recommending settlement to mention either the inquiry by any exchange or the lack of any such inquiry, and (d) the fact that Swan never even discussed regulatory investigations with his associate, S&C argued that (1) plaintiffs could not have relied on nonproduction of the documents to indicate that there was no NYSE investigation and (2) in any event, in light of the documents of which Swan was indisputably aware, any such reliance would not have been justifiable.

In opposition to S&C's motion for summary judgment, plaintiffs asserted that there were genuine issues of fact to be tried with respect to, *inter alia*, their contentions (a) that S&C had made an untrue implied representation that there were no documents relating to any inquiry by NYSE into Bache's marketing of the spreads, (b) that "Sullivan & Cromwell knew its representations were not true and that it had withheld requested documents," (c) that prior to December 1983, S&C "had in its possession all of the documents of the Exchange Inquiry and knew that they existed," and (d) that "[a]t all relevant times Sullivan & Cromwell intended to deceive Swan." Swan submitted an affidavit stating that he had relied on S&C's nonproduction as a representation that there was no NYSE investigation.

After submitting their opposition to the motion for summary judgment, plaintiffs moved for leave to amend their complaint in order to assert a claim against S&C under the New York Judiciary Law § 487 (McKinney 1983). That section provides, in pertinent part, that an attorney who "[i]s guilty of any deceit or collusion, or consents to any deceit or collusion with intent to deceive the Court or any party . . . [i]s guilty of a misdemeanor, and . . . forfeits to the party injured treble damages, to be recovered in a civil action." Plaintiffs' attorney stated that the claim had not been asserted in the original April 1987 *Cresswell II* complaint or in the amended complaints filed thereafter because counsel was unaware of this law.

In an Opinion dated January 12, 1989 ("Opinion"), the district court denied plaintiffs' motion to amend on the ground that it was inexcusably belated, and it granted S&C's motion for summary judgment on one of the three grounds advanced. The court ruled that summary judgment could not be granted on the basis of lack of intent because the record raised genuine issues of fact as to that element. While noting that there was no evidence that S&C knew about the December 1983 exchange of correspondence between NYSE and Bache until after *Cresswell I* was settled, the court found that when all inferences were drawn in favor of plaintiffs, as the nonmoving side, a question of fact existed as to whether S&C intentionally withheld the July 11, 1984 letter in hopes of achieving a settlement before the results of the inquiry became known. Further, the court found that summary judgment could not be granted for lack of materiality. Though noting that Shippy, who handled the investigation for Enforcement, testified that the investigation had "nothing to do with the individ-

uals who were suing the firm," the court observed that the test of materiality is what effect knowledge of the investigation would have had on a reasonable person in plaintiffs' position, not how the investigation would have been viewed by the Exchange or a bystander. Noting the larger settlements that were reached after disclosure of the Exchange investigation, the court concluded that there was a factual issue to be tried as to the materiality of the nondisclosure.

Nonetheless, the court found that, as a matter of law, plaintiffs could not show justifiable reliance on S&C's failure to produce the Bache-Exchange correspondence with regard to Gregory's complaint. Noting that when a party has the means of " 'knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations,' " 1989 Opinion at 48 (quoting *Cudemo v. Al & Lou Construction Co.*, 54 A.D.2d 995, 387 N.Y.S.2d 929, 930 (3d Dep't 1976)), the court found that plaintiffs were not entitled to complain of S&C's nondisclosure.

> Swan knew not only about the Polly Gregory exchange but that Sullivan and Cromwell had not produced them in response to his request. By June, 1984, at Gregory's deposition, Swan knew that Bache had corresponded with the NYSE, and that Sullivan and Cromwell had in its possession documents which Swan considered to be responsive to the Second Document Request, but which had not been produced. Swan conceded that at least one of the documents marked by Burnett was responsive to

his Second Document Request and had not been produced. Despite this, Swan did not ask Burnett—or anyone else at Sullivan and Cromwell—why any of the documents had not been produced in response to the Second Document Request or for the Polly Gregory file, nor was his document demand renewed or amended.

Under these circumstances, even if Swan did rely on Sullivan and Cromwell's representation, and even if he believed that the failure to turn over the documents was an inadvertent omission, his reliance on Sullivan and Cromwell's representation was not reasonable. He never sought to depose Goldenblum, although he knew that Goldenblum had communicated with the Exchange. He did not contact the Exchange, even though he knew that the Exchange sometimes examined customer complaints. He did not contact the CBOT—the Exchange on which the Spreads were traded—about its investigation, nor did he discuss the activities of regulatory bodies with his clients or even with his associate. For all of these reasons, Swan could not have reasonably relied on Sullivan and Cromwell's response.

. . . .

Swan's conclusory declaration that he relied upon Sullivan and Cromwell's representation is overcome by the undisputed facts set forth above. . . . Plaintiffs have failed to establish reasonable reliance, and Sullivan and Cromwell's motion for summary judgment is thus granted.

Opinion at 47-49.

Contemporaneously with S&C's summary judgment motion, Bache had moved to preclude Swan from testi-

fying in the case on the ground that his testimony would be a violation of professional ethics. Cooper-Brown's agreement with plaintiffs called for that firm to receive one-third of plaintiffs' net recovery, and Swan's agreement with Cooper-Brown called for him to receive "one sixth of the total net attorneys' fees" obtained by Cooper-Brown. In exchange, Swan agreed to waive and assign any claims he might have against the plaintiffs for further fees, or against Bache or S&C, and to continue working on the case as an attorney. Bache contended that this fee agreement violated the disciplinary Rules of the American Bar Association Code of Professional Responsibility.

The court denied Bache's motion to preclude Swan from testifying, stating that because "Swan's testimony on the facts provides direct evidence as to the conduct of the defendants[,] . . . [s]ubstantial justice requires the testimony." Opinion at 32. It ruled, however, that in light of the need for this testimony, Swan's collaboration with Cooper-Brown violated the rule prohibiting an attorney from representing a party in an action in which he will or should be called as a witness, *see* Disciplinary Rule 5-101(B). In addition, noting Swan's "admi[ssion] that, pursuant to the [fee] Agreement, his payment in this case will be 'contingent to a substantial extent' upon the outcome of the case and that he is a central fact witness for plaintiffs," Opinion at 23, the court ruled that the agreement violated Disciplinary Rule 7-109(C) of the Code, which prohibits payment to a witness of a fee that is contingent on the outcome of the case. Accordingly, the court ruled that Swan should be disqualified from working on the case except as a witness and barred from receiving a contingent fee in the action.

Following issuance of the Opinion granting summary judgment in favor of S&C, disqualifying Swan from representing plaintiffs, and voiding his contingent fee agreement, the parties stipulated to a dismissal of the claims against Bache. A final judgment was entered dismissing the complaint, and this appeal followed.

On appeal, plaintiffs contend principally that the district court erred in (a) granting summary judgment in favor of S&C, (b) refusing to allow them to amend their complaint, and (c) precluding Swan from serving as their attorney in this case and accepting a contingent fee. We consider initially, however, the question of federal jurisdiction, which was raised for the first time by this Court at oral argument. We conclude that the district court had jurisdiction, though not on the basis asserted below, and that in light of the proper basis for federal jurisdiction, it is appropriate to remand to the district court for consideration of S&C's motion to dismiss within the proper legal framework.

II. FEDERAL JURISDICTION

The complaint asserted two bases of subject matter jurisdiction: (1) diversity of citizenship "except as to [three named plaintiffs]," and (2) jurisdiction "ancillary and pendent to [*Cresswell I*] . . . and to the existence of Federal questions arising under the Commodity Exchange Act (7 U.S.C. § 1 et seq.), 28 U.S.C. §§ 1332 [*sic*] and 1927, and Federal Rules of Civil Procedure, including Rules 26(e), 34, 41(a) and 54(b)." At oral argument, we questioned the validity of these bases for the assertion of jurisdiction, and the parties filed supplemental briefs on this issue. For the reasons below, we conclude that there is neither diversity jurisdiction nor

:ederal question jurisdiction under the provisions relied on by plaintiffs. We are persuaded, however, that the district court had ancillary equitable jurisdiction to entertain the action.

A. *Diversity Jurisdiction*

The federal diversity statute, to the extent pertinent here, gives the district courts jurisdiction (a) over cases between "citizens of different States," and (b) over cases between "citizens of a State" and "citizens or subjects of a foreign State." 28 U.S.C. § 1332(a) (1988). It is well established that for a case to come within this statute there must be complete diversity and that diversity is not complete if any plaintiff is a citizen of the same state as any defendant. *See, e.g., Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365, 373-74 (1978); *Strawbridge v. Curtiss*, 7 U.S. (3 Cranch) 267 (1806). United States citizens who are domiciled abroad are neither citizens of any state of the United States nor citizens or subjects of a foreign state, and § 1332(a) does not provide that the courts have jurisdiction over a suit to which such persons are parties. Though we are unclear as to Congress's rationale for not granting United States citizens domiciled abroad rights parallel to those it accords to foreign nationals, the language of § 1332(a) is specific and requires the conclusion that a suit by or against United States citizens domiciled abroad may not be premised on diversity. *See Smith v. Carter*, 545 F.2d 909 (5th Cir.), *cert. denied*, 431 U.S. 955 (1977); *see also* 1 *Moore's Federal Practice* ¶ 0.74[4] (1990); 13B C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 3621, at 577-78 (1984).

According to the complaint, though most of the plaintiffs are citizens of foreign countries, three plaintiffs are

United States citizens who permanently reside abroad. Under the above principles, therefore, since not all of the plaintiffs are entitled to sue in federal court based on the diversity statute, plaintiffs may not maintain this suit on the basis of diversity.

In response to our raising this issue, plaintiffs have suggested that the three plaintiffs who are United States citizens residing abroad might be dropped from the suit. Though there is authority for permitting the dismissal of claims against nondiverse defendants in order to cure a defect in diversity jurisdiction, *see, e.g., Newman-Green, Inc. v. Alfonzo-Larrain*, 490 U.S. 826 (1989) (upholding power of court of appeals to dismiss claims against nondiverse defendants "with prejudice"), the dismissal of the three nonqualifying plaintiffs in the present case may not provide a cure, because S&C has advised the Court that several of its own partners are United States citizens who reside abroad and that at least one of them has maintained his primary residence in France for more than a decade. Plaintiffs have not challenged S&C's representation, and indeed, the complaint itself suggests that two of S&C's partners may be domiciled in foreign countries. If in fact any of S&C's foreign-residing United States citizen partners are domiciled abroad, a diversity suit could not be brought against them individually; in that circumstance, since for diversity purposes a partnership is deemed to take on the citizenship of each of its partners, *see Great Southern Fire Proof Hotel Co. v. Jones*, 177 U.S. 449, 456 (1900); *Lewis v. Odell*, 503 F.2d 445, 446 (2d Cir. 1974); *Coudert Bros. v. Easyfind International, Inc.* 601 F. Supp. 525 (S.D.N.Y. 1985), a suit against S&C could not be premised on diversity.

B. *Federal Question Jurisdiction*

Plaintiffs also pursue their contentions that the district court had jurisdiction to hear this case by reason of its federal question jurisdiction over *Cresswell I* and its power under 28 U.S.C. § 1927 to award plaintiffs attorneys' fees for increased costs as a result of the alleged nondisclosures in *Cresswell I*. We disagree.

In *Cresswell I*, the district court had federal question jurisdiction under 28 U.S.C. § 1331 because the claims in that action sought relief under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq*. That circumstance is not present here. None of the claims against S&C depends on the merits of plaintiffs' *Cresswell I* claims or the quality of Bache's disclosures to potential investors in its Spreads. There is no question here as to whether Bache's representations constituted violations of the Commodity Exchange Act, and there is no contention that the conduct of S&C violated any federal statute. Rather, plaintiffs' claim is that S&C committed common-law fraud.

Nor may federal question jurisdiction be premised on § 1927, for that section does not appear to authorize an independent lawsuit. It provides that an attorney "who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct." 28 U.S.C. § 1927. The power thereby described is the power of the courts to punish an attorney who conducts frivolous or dilatory litigation by awarding the other side compensation "as part of the costs in the litigation." *Roadway Express, Inc. v. Piper*, 447 U.S. 752, 770 (1980) (Stevens, *J.*, concurring in part and dissent-

ing from view that prior version of § 1927, which did not expressly mention attorneys' fees, did not mean "costs" to include such fees). Though under the present § 1927 "attorneys' fees were intended to be among the costs which a party could request after litigation was completed," the request for such an award is nonetheless made in the case in which the attorney's unreasonable conduct is alleged to have occurred. *See Gordon v. Heimann*, 715 F.2d 531, 537 (11th Cir. 1983). We have seen no basis for concluding that § 1927 was intended to permit a litigant to institute a new lawsuit to collect excess costs and fees incurred in a prior litigation. Indeed, since plaintiffs' claim is not that the proceedings in *Cresswell I* were multiplied but that plaintiffs are required to pursue the present action, this suit seeks recovery under § 1927 of excess costs and fees not yet incurred when the § 1927 claim was asserted. As a statute with a punitive thrust, § 1927 is to be strictly construed, *see Mone v. Commissioner of Internal Revenue*, 774 F.2d 570, 574 (2d Cir. 1985), and we cannot conclude that it provides a basis for the present suit.

The complaint's attempt to premise jurisdiction on the alleged violations of various Federal Rules of Civil Procedure is no more meritorious. The Rules do not provide an independent ground for subject matter jurisdiction over an action for which there is no other basis for jurisdiction. *See* Fed. R. Civ. P. 82 ("[t]hese rules shall not be construed to extend or limit the jurisdiction of the United States district courts . . ."); *see also Snyder v. Harris*, 394 U.S. 332, 337-38 (1969).

Notwithstanding the absence of federal question jurisdiction and the apparent absence of diversity, however, we conclude for the reasons below that the court had

ancillary equitable jurisdiction to entertain an attack on the *Cresswell I* judgment.

C. *Ancillary Equitable Jurisdiction*

Rule 60(b) provides, in pertinent part, that a party may make a motion seeking relief from a final judgment on the grounds of, *inter alia*, "fraud . . . , misrepresentation, or other misconduct of an adverse party." Fed. R. Civ. P. 60(b)(3). The Rule also states that provision for such a motion "does not limit the power of a court to entertain an independent action to relieve a party from a judgment [or] order." Fed. R. Civ. P. 60(b). The independent action referred to in this Rule is "what had been historically known simply as an independent action in equity to obtain relief from a judgment." 11 C. Wright & A. Miller, *Federal Practice and Procedure* § 2868, at 238 (1973).

If a party were to proceed under Rule 60(b) by motion in the underlying suit, the court would of course have jurisdiction to decide the motion because of its jurisdiction of the suit. An independent action for relief from the judgment, however, must be supported by its own jurisdictional grounds. When the basis for federal jurisdiction of the original suit no longer exists, either because there is no longer diversity of citizenship or because the claims in the new suit do not arise under federal law, the district court that entered the original judgment has inherent "ancillary" equitable jurisdiction to entertain the suit for relief from the judgment. *See, e.g., Pacific R.R. of Missouri v. Missouri Pac. Ry. Co.*, 111 U.S. 505, 521-22 (1884) (though the diversity on which jurisdiction of the earlier suit rested did not exist in the second suit, "there can be no doubt that the

[lower court that entered the earlier decree] had jurisdiction" over a suit to vacate that decree for alleged fraud); *Martina Theatre Corp. v. Schine Chain Theatres, Inc.*, 278 F.2d 798, 800 n.1 (2d Cir. 1960) (when the action to set aside judgment "is brought in the federal court that rendered the initial judgment, there is ancillary jurisdiction over the action despite absence of a federal question or diversity of citizenship").

Ancillary jurisdiction is sufficiently flexible that the action may be maintained against a person who was not a party to the original action. *See, e.g., Valerio v. Boise Cascade Corp.* 645 F.2d 699, 700 (9th Cir.) (per curiam), *cert. denied*, 454 U.S. 1126 (1981); 7 *Moore's Federal Practice* ¶ 60.38[1], at 60-398 (1990). For example, parties who seek to vacate a judgment on the ground of fraud on the court are allowed to join as defendants in the second suit persons who were attorneys, not parties, in the first suit. *See Valerio v. Boise Cascade Corp.* 645 F.2d at 700.

Since *Cresswell I*, like the present action, was brought in the Southern District of New York, we conclude that the district court had ancillary equitable jurisdiction over the present claims against S&C.

III. THE MERITS

On the merits, plaintiffs contend that (a) S&C was not entitled to summary judgment because there existed a genuine issue of fact as to whether Swan justifiably relied on S&C's implied representation that all pertinent documents had been produced; (b) the district court should have allowed them to amend their second amended complaint to assert another basis for recovery;

and (c) the court erred in barring Swan from participating in this case as plaintiffs' attorney and from accepting a contingent fee. We conclude that the claims against S&C should be remanded for consideration within the proper jurisdictional framework and that plaintiffs' other contentions lack merit.

A. *Summary Judgment in Favor of S&C*

In granting summary judgment in favor of S&C, the district court ruled that, as a matter of law, Swan could not reasonably have relied on S&C's nonproduction to conclude that there were no documents relating to any inquiry or investigation of the Bache Spreads by NYSE. We are inclined toward the view that, if this were an ordinary common-law fraud action, we would affirm. The issue of justifiability of reliance is not one that is inherently unsuitable for determination as a matter of law, and the record supports the district court's finding that Swan had actual knowledge that not all of the documents he thought he had called for had been produced. It is indisputable, for example, that Swan had some of the unproduced documents in his possession, having been given them by Gregory more than a year before the settlement. He also received copies of unproduced NYSE-related documents from S&C when he represented Gregory at her deposition; at that time Burnett explicitly identified those documents as having come from the files of Bache. Swan had available obvious means for determining whether there were other such documents or other information of which he was unaware, such as inquiring of S&C or contacting NYSE. Instead, he made no effort whatever to follow up or inquire. Considering this issue solely as a matter of law, we would conclude that the district court did not err in

ruling that if Swan relied on the earlier nonproduction to mean that there were no such documents, he did not do so justifiably.

As indicated in Part II.C. above, however, the present action is not an action at law but is one addressed to the court's equity powers. *See generally Martina Theatre Corp. v. Schine Chain Theatres, Inc.*, 278 F.2d 798; 7 *Moore's Federal Practice* ¶ 60.38[1] (1990). Decisions in such an action are committed to the court's discretion, informed by traditional equitable principles. Thus, in order to pursue an independent action to set aside a judgment, a plaintiff

> must show a recognized ground, such as fraud . . . , for equitable relief and that there is no other available or adequate remedy. *It must also appear that the situation in which the party seeking relief finds himself is not due to his own fault, neglect or carelessness.* In this type of action, it is fundamental that equity will not grant relief if the complaining party "has, or by exercising proper diligence would have had, an adequate remedy at law, or by proceedings in the original action * * * to open, vacate, modify, or otherwise obtain relief against, the judgment." The granting of relief in this unusual type of proceeding lies largely within the discretion of the trial judge.

Winfield Associates, Inc. v. Stonecipher, 429 F.2d 1087, 1090 (10th Cir. 1970) (emphasis added). Most important for purposes of the present case is the principle that in order to obtain the requested equitable relief, a plaintiff must show "the absence of fault or negligence" on his own part. *Bankers Mortgage Co. v. United States*, 423 F.2d 73, 79 (5th Cir.), *cert. denied*, 399 U.S. 927 (1970);

see 11 C. Wright & A. Miller, *Federal Practice and Procedure* § 2868, at 238.

In the present case, the district court did not make its findings within this framework. Rather, both the court and the parties treated the action as one at law and the court dismissed the claims against S&C solely on the basis of its ruling that any reliance by Swan was, as a matter of law, not justifiable. It is, of course, arguable that this ruling means that the court would not find that the situation in which plaintiffs find themselves is not due to their own attorney's neglect. Since, however, the court did not purport to decide the latter question or to exercise its discretion or its equitable powers, and since the decision of such questions should be made by the district court in the first instance, we conclude that the matter should be remanded for consideration in light of these principles.

B. *The Denial of Leave To Amend the Complaint*

In October 1988, plaintiffs unsuccessfully moved for leave to amend their complaint to include a claim under New York Judiciary Law § 487, which grants an injured party a private right of action for treble damages against an attorney who is guilty of intentionally deceiving the court. They contend that the district court's denial of their motion to amend was an abuse of discretion. We disagree.

Generally, permission to amend should be freely granted. *See Foman v. Davis*, 371 U.S. 178, 182 (1962). The court plainly has discretion, however, to deny leave to amend where the motion is made after an inordinate delay, no satisfactory explanation is offered for the delay, and the amendment would prejudice the defen-

dant. *See, e.g., Tokio Marine & Fire Insurance Co. v. Employers Insurance of Wausau*, 786 F.2d 101, 103 (2d Cir. 1986). The burden is on the party who wishes to amend to provide a satisfactory explanation for the delay, *see Sanders v. Thrall Car Mfg. Co.*, 582 F. Supp. 945, 952 (S.D.N.Y. 1983), *aff'd*, 730 F.2d 910 (2d Cir. 1984), and the court is free to conclude that ignorance of the law is an unsatisfactory excuse, *see, e.g., Goss v. Revlon, Inc.*, 548 F.2d 405, 407 (2d Cir. 1976).

In the present case, plaintiffs filed their initial complaint in April 1987. In May 1987, they filed an amended complaint. In March 1988, near the end of a yearlong period of discovery, plaintiffs were allowed to file a second amended complaint. In July 1988, discovery having been completed, S&C moved for summary judgment. Plaintiffs responded to that motion in August 1988. They did not move to amend their second amended complaint to assert the § 487 claim until September 30, 1988, *i.e.*, more than 17 months after bringing suit, more than six months after filing their second amended complaint, and more than one month after responding to the motion for summary judgment. The only excuse offered for the delay was that plaintiffs' counsel had been unaware of § 487.

The district court denied the motion to amend, noting that § 487 was hardly new, having been in effect in its present form for some two decades, and finding that S&C would be prejudiced by plaintiffs' inordinate delay in making this motion. In all the circumstances, we see no abuse of discretion in the denial of the motion.

C. *The Disqualification of Swan*

Finally, plaintiffs challenge the district court's order disqualifying Swan from participation in this case as

their attorney and barring him from receiving a contingent fee. They contend principally that Disciplinary Rules 5-101(B) and 7-109(C) of the Code of Professional Responsibility were not applicable because the fee agreement between Swan and Cooper-Brown states that Swan's "rights to payment . . . shall be entirely independent of [his] testimony and shall not be affected if [he does] not testify," and that the court should have refrained from disqualifying Swan because Disciplinary Rule 5-101(B)(4) makes an exception for cases in which the client will suffer a "substantial hardship" if the attorney cannot represent him. We reject these arguments.

The disqualification of an attorney in order to forestall violation of ethical principles is a matter committed to the sound discretion of the district court. *See, e.g., Allegaert v. Perot*, 565 F.2d 246, 248 (2d Cir. 1977); *W.T. Grant Co. v. Haines*, 531 F.2d 671, 676 (2d Cir. 1976); *Hull v. Celanese Corp.*, 513 F.2d 568, 571 (2d Cir. 1975). Disciplinary Rule 5-101(B) of the ABA Code provides that "A lawyer shall not accept employment in contemplated or pending litigation if he knows or it is obvious that he . . . ought to be called as a witness . . . ." Disciplinary Rule 7-109(C) provides that "A lawyer shall not . . . acquiesce in the payment of compensation to a witness contingent upon the content of his testimony or the outcome of the case."

Notwithstanding the language of Swan's fee agreement, purporting to make his right to payment independent of his testimony, the facts remain that (a) the agreement gave Swan the right to receive one-sixth of any fees received in this by Cooper-Brown, (b) Cooper-Brown's fee was contingent on plaintiffs' recovery, and

(c) Swan's testimony would be essential to the proof of plaintiffs' claims. The disqualification of Swan was appropriate substantially for the reasons stated by the district court and was well within the bounds of discretion. Nor have plaintiffs shown any respect in which they will suffer hardship if Swan is allowed only to testify and not to act as their attorney and if he is barred from agreeing to a contingent fee. The record provides no basis on which we might conclude that the hardships to plaintiffs, if any, would outweigh the ethical considerations.

After oral argument of this appeal, plaintiffs wrote to advise us that New York State would soon adopt a modified version of Disciplinary Rule 5-101(B) allowing an attorney who is to be a trial witness to represent a party in a capacity other than that of "advocate." Such a modification would appear to have no bearing on the ruling that Swan may not accept a contingent fee. However, we do not preclude the district court's reconsideration, if necessary, of the extent of Swan's disqualification in the light of any pertinent new rules.

CONCLUSION

We have considered all of plaintiffs' arguments challenging the district court's judgment and orders, and, except to the extent indicated above, have found them to be without merit. The judgment dismissing the claims against S&C is vacated, and the matter is remanded to permit the district court to consider those claims as a court of equity.

No costs.

Edward CRESSWELL, et al., Plaintiffs,

v.

SULLIVAN & CROMWELL and Prudential-Bache Securities, Inc., Defendants.

Percy Herbert MEADOWS, Jorgen Hellzen, Chalais Holdings Limited, Elizabeth E. Noble, Ghasson Nagib Pharaon, Gerhardt Schulte-Heuthaus, and Roderick R. Von Etzdorf, Plaintiffs,

v.

SULLIVAN & CROMWELL and Prudential-Bache Securities, Inc., Defendants.

Nos. 87 Civ. 2685 (RWS), 88 Civ. 2221 (RWS).

United States District Court, S.D. New York.

Jan. 11, 1989.

OPINION

SWEET, District Judge.

Defendant Prudential-Bache Securities Inc. ("Bache") has moved *in limine* to preclude the deposition and trial testimony of Edward J. Swan, Esq. ("Swan") who represented certain of the plaintiffs in *Cresswell v. Prudential-Bache Securities, Inc.*, 83 Civ. 2099 (RWS) ("*Cresswell I*") on the grounds that the contingency fee arrange-

ment between Swan and counsel for the plaintiffs here, Richard Cooper, Esq. ("Cooper") is improper. Sullivan and Cromwell has moved pursuant to Fed.R.Civ.P. 56 for summary judgment to dismiss the complaint in this action of Plaintiffs Edward Cresswell et al ("*Cresswell II*"). Plaintiffs have moved to further amend the Second Amended Complaint by adding a Fifth Claim for Relief against Sullivan and Cromwell. In a related case, *Meadows v. Sullivan and Cromwell and Prudential-Bache Securities, Inc.*, 88 Civ. 2221 (RWS) ("*Meadows*"), the *Meadows* plaintiffs have moved pursuant to Fed.R.Civ.P. 42(a) to consolidate their action with this one, "*Cresswell II*". Upon the reasons, facts and conclusions set forth below, Bache's motion to preclude the testimony of Swan, Plaintiffs' motion to amend the Second Amended Complaint, and the *Meadows* plaintiffs' motion to consolidate are denied, and Sullivan and Cromwell's motion for summary judgment is granted.

Briefly stated, the amended complaint alleges that Bache and Sullivan and Cromwell deliberately withheld information subject to discovery during the course of an earlier action between the *Cresswell I* plaintiffs and Bache, and that this withholding constitutes grounds for rescinding the settlement of the earlier action and for an increased award of damages which would have resulted, had the withheld in-

formation been revealed. That information related to the initiation of a proceeding by the New York Stock Exchange (the "NYSE") into Bache's activities in connection with the sale of securities which were the subject of *Cresswell I.* The propriety of the conduct of attorneys in litigation is the underlying issue in the disposition of these motions. The skill of counsel for both sides has greatly assisted in the determination of these issues which are vexing, sensitive, and by their nature particularly appropriate for resolution at this stage of the litigation.

Prior Proceedings

The present action was commenced in April, 1987, alleging that the exchange between Bache and the NYSE in December, 1983 had been deliberately withheld. The Complaint alleged that the nonproduction of the documents caused plaintiffs to settle *Cresswell I* for less than they otherwise would have.

Certain of the prior proceedings of this case are set forth in this court's opinion of July 31, 1987, familiarity with which is assumed, which denied Sullivan and Cromwell's motion pursuant to Rule 12(b)(6) Fed. R.Civ.P. to dismiss the amended complaint. *Cresswell v. Sullivan and Cromwell*, 668 F.Supp. 166 (S.D.N.Y.1987). Discovery has proceeded in this action and has largely been completed.

On March 31, 1988, certain of the former plaintiffs in *Cresswell I* filed a separate action (*Meadows*), seeking the same relief requested by the Plaintiffs in *Cresswell II*. Although there has been little, if any, discovery in *Meadows*, aside from any discovery relating to the particular plaintiffs, this court determined in June, 1988 that plaintiffs in *Meadows* could have access to the discovery material gathered by *Cresswell II* discovery.

The Bache motion to disqualify Swan was heard on July 21, 1988, and its disposition was deferred until the disposition of the remaining motions which were heard on October 21, 1988.

FINDINGS OF FACT

The Underlying Investment

In 1981–82, Bache recommended in Europe an investment program based upon the spread between the price of GNMA futures contracts and the price of Treasury Bond futures (the "Spreads"). Certain publications issued by Bache were alleged by all plaintiffs to have been misleading. In October, 1982, the spread widened beyond its historic position, and the plaintiffs were required to liquidate their positions, incurring losses.

Cresswell I

In March, 1983, sixty plaintiffs represented by Swan filed a complaint alleging

that Bache had made materially false and misleading statements in connection with the marketing of the Spreads and seeking $2.87 million in compensatory damages and $200 million in punitive damages (*Cresswell I*). Eventually, more than 80 plaintiffs sought $5.68 million in compensatory damages and $208 million in punitive damages.

Marvin Schwartz ("Schwartz"), a senior litigation partner at Sullivan and Cromwell, was in charge of the matter for Bache, and was assisted by Sullivan and Cromwell associates Howard Burnett ("Burnett") and John L. Hardiman ("Hardiman"). The parties in *Cresswell I* reached a settlement in early 1985 pursuant to which Bache paid the plaintiffs in *Cresswell I* and a similar case, *Wallin, et al v. Prudential-Bache Securities, Inc.*, 84 Civ. 7192 (RWS), a total of approximately $2.7 million, or 46% of the claimed dollar losses in those actions, and forgave debit amounts due from several plaintiff-customers.

Polly Gregory Documents, the July 14 Letter and the NYSE Inquiry

On January 6, 1983, prior to the initiation of *Cresswell I*, an investor, Polly Gregory ("Gregory"), later a plaintiff in *Cresswell I*, wrote to the NYSE complaining of losses in connection with the Spreads sold by Bache in Europe and seeking assistance in recouping her losses. Gregory's letter was referred to the NYSE Division of Member Firm Regulatory Services, where it came to

the attention of a Review Specialist, Barbara Krupinski ("Krupinski"). On February 1, 1983, Krupinski forwarded Gregory's letter to Bache and requested that Bache respond to the complaint and send information to the NYSE related to the marketing of the Spreads.

On March 15, a Bache memorandum was forwarded to William Goldenblum ("Goldenblum"), a Bache lawyer in Paris, regarding "correspondence received from the New York Stock Exchange regarding ... allegations against our firm." On March 28, 1983, Goldenblum responded to Krupinski by letter. Goldenblum denied without explanation that the pamphlet marketing the Spreads was misleading. The NYSE, in turn, forwarded Goldenblum's letter to Gregory. On May 4, 1983, Goldenblum again wrote to the NYSE. On May 13, Krupinski repeated a request made by telex in late April and then asked Goldenblum by letter to send her a copy of a 1981 advertisement on the Spreads and information concerning the advertisement. On May 26, 1983, Goldenblum sent Krupinski a copy of the advertisement. By letter of June 6, 1983, Goldenblum told Hardiman of Sullivan and Cromwell that the NYSE "has raised the question of the ad," and enclosed a copy of his file relating to Polly Gregory. On June 7, Barbara D. Salmanson ("Salmanson"), a Bache attorney specializing in commodities law, told Goldenblum that

Schwartz wanted to see the ad before rendering advice.

Schwartz then helped Bache prepare a response to the NYSE inquiry on the advertisement. His draft of this letter has not been preserved. Salmanson signed the letter, approved by Schwartz, which was sent to Krupinski on June 8, 1983. A copy of the letter was also sent to Hardiman. In the letter, Bache informed the NYSE that the advertisement on the Spreads had been reviewed prior to publication in the *London Financial Times*, and that since the Bache reviewer "assumed that the brochure referred to in the advertisement was in fact available to the public," it was felt that the advertisement would not violate NYSE standards. At some time in mid 1983, Gregory's letter of complaint and the Bache responses were referred by the Regulatory Services of the NYSE to its Department of Enforcement.

On December 5, 1983, Loren Schechter ("Schechter"), General Counsel of Bache, received a letter from Donald E. Shippy ("Shippy"), a Senior Enforcement Investigator from the Department of Enforcement indicating that the Exchange was "investigating the possibility that ... Bache ... may have violated the standards for advertising and sales literature contained in ... the Exchange Rules" with regard to the advertisement and brochure on the

Spreads (the "December 5 Letter"). On December 9, 1983, Schechter responded to the Exchange with a brief letter indicating that he would "look into the matter promptly and be in touch ..." (the "December 9 Letter").

On December 13, 1983 Shippy held a phone conversation with Schechter and Salmonson. In his memorandum of that conversation, Shippy wrote:

> Pru-Bache, according to Mr. Schechter, is currently the subject to 83 suits seeking $5,000,000 in damages. Because of this civil litigation, the firm cannot take a hit because [of] this alleged rule violation and will contest us if we bring charges against them.

In January, 1984, Gregory, who had become a *Cresswell I* plaintiff in December, 1983, provided Swan with some of her correspondence with the NYSE including Goldenblum's March 28 response. In June, 1984, Burnett deposed Gregory on behalf of Sullivan and Cromwell and marked as exhibits four documents concerning the Exchange inquiry including Gregory's January 6, 1983 complaint letter and Goldenblum's March 28 response. When Burnett marked certain of the documents, he told Gregory and Swan that some of the documents had come from the files of Bache.

After Gregory was deposed, Swan asked her to send him all of her correspondence

with the Exchange. After waiting almost three months, he asked her again for the Exchange communications, and then only after Sullivan and Cromwell demanded the documents by letter and finally by motion seeking to compel production. On September 19, 1984, Gregory finally sent Swan the documents.

In July 1984, Salmanson called Burnett to tell him that she was drafting a letter to the NYSE and wanted to know whether the discovery Burnett had taken in London confirmed what she intended to put in the letter. Salmanson sent the letter dated July 11, 1984 to Shippy at the NYSE Department of Enforcement (the "July 11 Letter") and sent a copy to Burnett, who sent copies to Schwartz and Hardiman. The July 11 Letter describes the brochure used in connection with the Spreads, explaining that although the brochure "did not address in detail the risks involved in interest rate future trading, the ... strategy was explained to clients in the context of futures trading." The letter also points out that investors signed the Commodities Future Trading Commission ("CFTC") mandated Risk Disclosure Statement and Bache's suitability letter, "both of which described the risk of futures trading." After the receipt of this letter, the Exchange investigation slowed down.

In August 1985, Bache and the NYSE

settled the investigation by executing a Stipulation of Facts and Consent to Penalty in which Bache consented to a censure and a $5000 fine, "without admitting or denying guilt." On October 21, 1985, the NYSE issued a decision based upon the stipulation. The Exchange found that the Bache brochure did not adequately disclose the risks of investing in the Spreads.

On January 2, 1986 the Securities and Exchange Commission ("SEC") made public its findings based on the NYSE action censuring Bache. *In the Matter of Prudential-Bache Securities, Inc. et al.* On February 12, 1986, the *Wall Street Journal* reported the settlement between Bache and the NYSE.

The Settlement of Cresswell I

Settlement discussions in *Cresswell I* began in the summer of 1984. Sullivan and Cromwell recommended to Bache a settlement amount. In November, 1984, Swan met with the investor association in London to discuss the potential settlement offer; the offer met with approval. In a ten page letter to his clients, Swan recommended the settlement. Swan advised that the central issue in the *Cresswell I* case was not whether Bache made misleading representations about the Spreads, but whether it was reasonable for the sophisticated investors to have relied upon misstatements.

This was given particular relevance since many of the investors had not read the sales literature but had invested in the Spreads after hearing oral representations by Bache employees. Nowhere in the ten-page letter did Swan mention as a factor in favor of settlement that no regulatory bodies were investigating the Spreads, or that regulatory bodies had investigated but had taken no action upon the investigation. All but two *Cresswell I* plaintiffs agreed to settle by February, 1985.[1] Judgments were entered dismissing the actions.

Discovery in Cresswell I

On April 26, 1983, plaintiffs made their first document request in *Cresswell I*, seeking production of twelve categories of documents. Hardiman coordinated the search after seeking from Bache all documents relating to the Spreads in order for Sullivan and Cromwell to determine their responsiveness. On November 18, 1983, Hardiman wrote to the manager of Bache's London office requesting him to double-check his files for "anything even remotely responsive to the request." On November 22, 1983, Sullivan and Cromwell produced

1. Merana Ltd. ("Merana") and G.G. Chaplin ("Chaplin") did not settle at that time. Merana settled in September, 1986 for $300,000 plus legal fees. Chaplin tried his claim *pro se* and achieved a return of his out-of-pocket losses. *Cresswell v. Prudential-Bache Securities, Inc.*, No. 83 Civ. 2099 (S.D.N.Y., Nov. 23, 1987).

over 2,600 pages of documents in response to plaintiffs' request. Among the documents produced were documents indicating investigations of the Spreads by the Chicago Board of Trade ("CBOT"), the exchange in which the Spreads were traded, and by the London Department of Trade.

On December 9, 1983, plaintiffs served their second document request (the "Second Document Request" or the "Request"). Paragraph 1 of the Request called for:

> [a]ny and all documents relating to any investigation or inquiry by any exchange, regulatory agency, or governmental body (whether in the United States or abroad) relating to defendant's marketing of the GNMA/T-Bond Spread which is the subject of this action.

Hardiman sent this request to Goldenblum in Bache's Paris office on December 13, 1983.[2]

Sullivan and Cromwell responded to the Second Document Request on December 16, 1983, stating that: "[w]ithout waiving any objections Prudential-Bache will produce documents responsive to this ... request." Again, among the documents produced were documents concerning the CBOT and the London Department of Trade, but no documents relating to the

2. Hardiman believes that he also sent the Request to Salmanson, a Bache attorney in New York. In any case, the next business day after the response to the Request was served, Salmanson received a copy of the Request.

NYSE inquiry were produced on behalf of Bache. The CBOT letter, dated October 27, 1982, requested information from Bache "explaining the circumstances surrounding the trades and losses," copies of Bache literature marketing the Spreads, customers' names, account numbers and account statements.

At his deposition in connection with this litigation, Schwartz testified that in December 1983, before responding to the Second Document Request, he and Hardiman discussed whether production of documents relating to Gregory's letter to the NYSE was required. According to Schwartz, they decided that the documents did not relate to an "investigation or inquiry" by an exchange within the meaning of the Request.

Because Gregory's complaint was being handled by the Division of Member Firm Regulatory Services and not by the Department of Enforcement, Schwartz decided that production of the Polly Gregory documents was not required by the document request and that the chance that a customer complaint would lead to a Department of Enforcement investigation was remote. Krupinski of the NYSE later testified that it was "rare" for customer complaints to lead to disciplinary action, and said that only 5% of the complaints she handled even reached the stage of a recommendation to her supervisor that the Department of Enforcement investigate. In addition,

Schwartz testified that he did not think "that there was any ambiguity about Swan's document request" at the time.

Hardiman, however, testified that he did not see some of the Polly Gregory documents in 1983, cannot recall others, and made no conscious decision not to produce them. As for Gregory's initial complaint letter of January 6, 1983, he testified that he knows he never saw it before 1986. Sullivan and Cromwell interpreted the Request to call for documents relating to "investigations or something like an investigation which has the potential for leading to a disciplinary charge."

In addition to the Polly Gregory documents, Sullivan and Cromwell did not produce the December 5 and December 9 letters in response to the Second Document Request. No evidence has been adduced to establish that Sullivan and Cromwell was aware of those letters prior to 1986. Sullivan and Cromwell did not represent Bache in connection with the NYSE inquiry which was handled by Bache in-house lawyers. Schechter had become General Counsel of Bache in April, 1983, and shortly thereafter, informed Schwartz that regulatory and self-regulatory matters would be handled by Bache in-house. Indeed, according to Sullivan and Cromwell, neither Hardiman nor Schwartz had been directly informed by Bache of the Exchange investigation or the settlement of the investiga-

tion, even though Sullivan and Cromwell was representing Bache in connection with *Cresswell I.*

After reviewing the February 1986 Wall Street Journal article publicly disclosing the NYSE investigation, Hardiman requested from Bache all documents relating to the investigation. Salmanson sent the file to Hardiman with a letter stating: "I am sorry that I may not have kept you fully apprised of the developments therein." The file contained the December 5 and December 9 letters. According to Sullivan and Cromwell, this was the first time that the firm had seen them.

Sullivan and Cromwell also never produced for the plaintiffs the July 11, 1984 Letter. The July 11 Letter was created seven months after the Second Document Request, and, according to Schwartz and Hardiman, no Sullivan and Cromwell lawyer focused on the Document Request in connection with the letter. Schwartz testified that although the address on the letter made it clear as of July 1984 that the Department of Enforcement of the Exchange was investigating the Spreads, Schwartz does not recall reading the letter, but assumes that he did. Apart from the fact that it was addressed to the Department of Enforcement, the July 11 Letter does not imply that an Exchange investigation had been undertaken as of December, 1983.

Following the Gregory deposition, Swan made no inquiry of Sullivan and Cromwell concerning the NYSE document which had not been produced. He also made no inquiries of the NYSE and the CBOT, the CFTC or the London Board of Trade.

Other Documents

In addition to the Polly Gregory documents, the December 5 and 9 letters and the July 11 letter, plaintiffs have alleged fraudulent failure to produce a publicly reported opinion, *Kotz v. Bache Halsey Stuart, Inc.*, 685 F.2d 1204 (9th Cir.1982), a decision argued by Schwartz,[3] in response to the second paragraph the Second Document Request which requested "findings, decisions, orders or conclusions of law resulting from any investigation, inquiry, lawsuit, arbitration, mediation or reparations or enforcement proceeding ... which find or state that ... [Bache] engaged in fraud or misrepresentation...." Plaintiffs also allege that Sullivan and Cromwell failed to produce other respon-

3. Sullivan and Cromwell points out that the *Kotz* decision was obviously known to plaintiffs, for it was the principal case cited to Swan in a research memorandum prepared by his associate during *Cresswell I.*

sive reported decisions.[4] In addition, plaintiffs allege that a CBOT letter announcing that an investigation into the Spreads had been terminated upon a determination that no Rule violations had occurred was not produced, nor was a summary of a meeting with the London Department of Trade concerning the Spreads.

Discovery in Merana and Reitz

Merana, one of the *Cresswell I* plaintiffs declined to settle and pursued its claim represented by Andrew Berger, Esq. ("Berger"). On February 12, 1986, the day of the Wall Street Journal article concerning the SEC action, Berger called Hardiman and demanded production of all documents, a demand on which argument was heard on March 14, 1986. In March, Hardiman conducted a search of Sullivan and Cromwell's files, but did not locate the Polly Gregory documents. Hardiman later gave the file, including the December letters, to Berger, who gave it to Swan. The file included the letters of December 5 and December 9, documents reflecting the NYSE investiga-

4. As examples of these omissions, plaintiffs cite *Poplar Grove Planting and Refining Co., Inc. v. Bache Halsey Stuart, Inc.*, 465 F.Supp. 585 (M.D. La., 1979); *Commercial Iron & Metal Co. v. Bache Halsey Stuart, Inc.*, 581 F.2d 246 (10th Cir.1978); *Newman v. Bache Halsey Stuart Shields, Inc.*, C.F.T.C., 1983, CCH ¶ 21,811, and the lower court decision in *Knieriemen v. Bache Halsey Stuart Shields Inc.*, 74 A.D.2d 290, 427 N.Y.S.2d 10 (2d Dep't 1980).

tion and settlement, and some of the Polly Gregory documents. The entire Polly Gregory file kept at Bache was not produced by Sullivan and Cromwell until February 1988 in this proceeding.

Schwartz testified that he never thought about producing the letters, or about F.R. Civ.P. 26(e) which requires that a party amend a prior response to a request for discovery if the party obtains information upon the basis of which it knows that the response was incorrect when made. Sullivan and Cromwell thus did not produce any more documents than it had produced in *Cresswell I.*

On April 4, 1986, Swan wrote to Hardiman complaining that the December 5 and 9 letters had not been produced in *Cresswell I.* Swan's letter made no mention of the Polly Gregory documents which had started the investigation. Swan requested an additional settlement amount from Schwartz, who refused, disagreeing that additional compensation was owing to plaintiffs.

In 1986, Swan also represented another plaintiff who had participated in the Spreads in *Reitz et ano. v. Bache*, 86 Civ. 4191 (RWS) ("*Reitz*") and served the same document demand. On July 25, 1986, Sulli-

van and Cromwell responded that all documents had been produced, although such was not the case.[5]

Later Settlements

In July, 1986, seventeen months after the settlement of *Cresswell I* and ten months after the NYSE censured Bache, Merana settled with Bache for 93.99% of the claimed losses, a greater percentage of the claim than it had paid to the plaintiffs in *Cresswell I*. The plaintiffs in *Reitz* settled their claims in January 1987 for 71% of the claimed losses, also a greater percentage recovery than Swan had obtained for the *Cresswell I* plaintiffs.

The Present Role of Swan

The day before Swan was deposed in this action, Sullivan and Cromwell and Bache learned that at least eight months earlier, Swan entered into an agreement with counsel for the plaintiffs in *Cresswell II* pursuant to which Swan would share in the contingency fee agreed upon with the plaintiffs in *Cresswell II* (the "Swan Agreement"). Under the Swan Agreement,

5. By this time Sullivan and Cromwell had obtained Bache and NYSE documents by subpoena of the Exchange in *Merana*. These documents were arguably not subject to production in *Reitz* by virtue of work product privilege which, however, was not claimed. Certainly the NYSE documents put Sullivan and Cromwell on notice that the earlier production in *Cresswell I* was inadequate.

Swan undertook to "waive and assign" to the plaintiffs in *Cresswell II* any claims against Sullivan and Cromwell and Bache arising out of his representation in *Cresswell I*, and to perform legal work in connection with *Cresswell II*, and to testify as a witness for the plaintiffs with respect to the facts of the conduct of Sullivan and Cromwell and Bache and its effect on the plaintiffs. In return, the plaintiffs will pay Swan one-sixth of the contingency fee to be received by Cooper in the action, and, on account, one-third of retainer payments held in non-segregated accounts by counsel to the plaintiffs. One-half of the amount to be paid to Swan is allocated in his waiver and assignment to the current plaintiffs of any claim he might have to a fee arising from his representation in *Cresswell I*. The other half is for work in connection with this action. The Swan Agreement includes a paragraph which states:

> If, despite our analysis of the propriety of what we are doing, we should hereafter see that this arrangement is somehow improper, or if a court should so hold, then anything above notwithstanding, [Swan's] entitlement to payment will be reduced or modified in order to achieve complete propriety and, to the extent possible, to be fair to [Swan].

CONCLUSIONS

The Code of Professional Responsibility: Rule 5–101(B) and Rule 7–109(C)

The Bache motion raises the issue as to whether Swan's deposition and anticipated trial testimony violate Disciplinary Rules 5–101(B) and 7–109(C) of the Code of Professional Responsibility of the American Bar Association. As has been previously stated, "the application of the Code is a part of the court's general supervisory authority to ensure fairness to all who bring their cause to the judiciary for resolution." *Freschi v. Grand Coal Venture*, 564 F.Supp. 414, 417 (S.D.N.Y.1983) (Sweet, J.) (citations omitted). Further, although "this court is not under a statutory duty to apply the Code as enacted by the American Bar Association," *United States v. Perlmutter*, 637 F.Supp. 1134, 1137 (S.D.N.Y. 1986) (Sweet, J.) (citing *International Electronics Corp. v. Flanzer*, 527 F.2d 1288, 1293 (2d Cir.1975)), the Code has been adopted by the State Bar Association of New York and its canons are recognized as appropriate guidelines for the professional conduct of New York lawyers. *See Cinema 5, Ltd. v. Cinerama, Inc.*, 528 F.2d 1384, 1386 (2d Cir.1976); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 567 F.2d 225, 227, n. 2 (2d Cir.1977); *NCK Organization Ltd. v. Bregman*, 542 F.2d 128, 129 n. 2 (2d Cir.1976).

Rule 5–101(B) of the Code provides:

> A lawyer shall not accept employment in contemplated or pending litigation if he knows or it is obvious that he ... ought to be called as a witness, except that he may undertake the employment and he ... may testify:
>
> (1) If the testimony will relate solely to an uncontested matter.
>
> (2) If the testimony will relate solely to a matter of formality and there is no reason to believe that substantial evidence will be offered in opposition to the testimony.
>
> (3) If the testimony will relate solely to the nature and value of legal services rendered in the case by the lawyer or his firm to the client.
>
> (4) As to any matter, if refusal would work a substantial hardship on the client because of the distinctive value of the lawyer or his firm as counsel in the particular case.

Because the Swan Agreement specifies that one-half of the contingency fee is for legal work performed by Swan, Rule 5–

101(B) applies.[6] *See, e.g., Hoerger v. Board of Education*, 129 A.D.2d 659, 660–61, 514 N.Y.S.2d 402, 403–04 (2d Dept. 1987); *Hempstead Bank v. Reliance Mortgage Corp.*, 81 A.D.2d 906, 906, 439 N.Y.S. 2d 202, 203 (2d Dept.1981); *North Shore Neurosurgical Group v. Leivy*, 72 A.D.2d 598, 598–99, 421 N.Y.S.2d 100, 101–02 (2d Dept.1979).

The first three exceptions to the prohibitions of 5–101(B) are not relevant here. Swan relies on exception (4) to justify his arrangement with counsel for the plaintiffs, claiming that because of his lengthy relationship with *Cresswell I*, he has developed an extensive, unique knowledge of that case as well as additional expertise in commodities law, rendering him of "distinctive value" in *Cresswell II*. Swan cites *Lumbard v. Maglia, Inc.* for the proposition that the application of the exception in DR 5–101(B)(4) makes disqualification of a lawyer unnecessary where disqualification would "work a substantial hardship" on the plaintiff. 621 F.Supp. 1529, 1540 (S.D.N.Y. 1985). *See also Warner Bros. Inc. v. Dae Rim Trading, Inc.*, Slip Op. 84 Civ. 4675 (IBW) (S.D.N.Y. Mar. 19, 1987) [1987 WL

6. Although Swan claims that part of his fee is for legal work on *Cresswell II*, deposition testimony of several plaintiffs in this case indicates that they do not consider Swan to be their attorney. Indeed, in a letter to his former clients, Swan himself noted that he could not be their attorney in *Cresswell II* because he would be a witness and a party in the new case.

8341] (the court refused to disqualify attorney where actions had been pending more than two and a half years and the work of present counsel was extensive, and where considerable delay and expense would be required for new counsel to take over).

According to Bache, however, Swan has no "distinctive value" to this case except as plaintiffs' central fact witness. It claims that there is nothing so distinctive about the law or facts in this case that Swan's absence as an attorney would result in significant hardship to plaintiffs, and points out that both the attorneys for defendants and present counsel for the plaintiffs have been able to acquire enough knowledge of this case to represent their clients.

In addition to exception (4) of 5–101(B), the plaintiffs urge that DR 5–101(B) is no longer applicable, and that the narrower Rule 3.7 of the newer ABA Model Rules, adopted by the ABA in 1983, should apply where 5–101(B) was once used. According to Rule 3.7, "[a] lawyer shall not *act as advocate* at a trial in which the lawyer is likely to be a necessary witness . . ." (emphasis added). Because the Swan Agreement provides that Swan will not perform services at trial (apart from his role as witness), plaintiffs contend that Swan is within the bounds of Rule 3.7. While it might be true that Rule 3.7 is not violated by the Swan Agreement, New York still

follows DR 5–101(B).[7] To the extent that Swan is performing legal services for *Cresswell II* plaintiffs, Swan's role as an attorney and witness violates Rule 5–101(B).

Even if Swan is not in violation of DR 5–101(B), Swan's testimony in *Cresswell II* puts him in violation of Disciplinary Rule 7–109(C) of the Code of Professional Responsibility, which states that:

> A lawyer shall not pay, offer to pay, or acquiesce in the payment of compensation to a witness contingent upon the content of his testimony or the outcome of the case.

The rationale for this rule is found in Ethical Consideration 7–28:

> Witnesses should always testify truthfully and should be free from any financial inducements that might tempt them to do otherwise. A lawyer should not pay or agree to pay a nonexpert witness an amount in excess of reimbursement for expenses and financial loss incident to his being a witness; however, a lawyer may pay or agree to pay an expert witness a reasonable fee for his services as an expert. *But in no event should a lawyer pay or agree to pay a contingent fee to any witness.*

(Emphasis added)

7. The New York State Bar Association has never adopted the ABA Model Rules.

Swan has admitted that, pursuant to the Swan Agreement, his payment in this case will be "contingent to a substantial extent" upon the outcome of the case and that he is a central fact witness for plaintiffs. Thus, his testimony is in direct conflict with Rule 7–109(C).

Case law confirms that witnesses should not be paid on a contingency basis. In *Person v. Association of the Bar of the City of New York*, the Court of Appeals for the Second Circuit explained that Rule 7–109(C) has been incorporated into the laws of New York and reflects a legislative judgment of "the need for discouragement of contingent fee arrangements." 554 F.2d 534, 538 (2d Cir.1977). The Court continued: "[d]isciplinary Rule 7–109 C was promulgated to insure that judicial proceedings in New York were free of false testimony which might result if expert witnesses were paid on a contingent fee basis." 554 F.2d 534, 538. More recently, in *Cosgrove v. Sears Roebuck and Co.*, this Court held that where an expert witness was to receive payment only if plaintiff won the case, Rule 7–109 was violated, for the fee arrangement was "contingent on its face." The testimony of the expert witness was thus precluded. No. 81 Civ. 3482 (CSH) (S.D.N.Y. Dec. 16, 1987) [1987 WL 33595] [1987 U.S. Dist. LEXIS 11696].

Opinions of the New York City and New York State Bar Associations have also sup-

ported this rule against contingency payments. *See, e.g.*, NYC Bar Assn. Op. No. 76 (1927–28) ("[a]n agreement to pay a witness compensation measured by the result of his testimony [i.e. contingent upon the result of the litigation] is a temptation to perjury and should be avoided); NYC Bar Assn. Op. No. 553 (1940) (where two attorneys have become aware that payment of a fee owing to them by a former client is contingent upon the outcome of a new suit in which the attorneys are not the lawyers, they must not testify in the former client's suit except under subpoena or court order); NYS Bar Assn. Op. No. 547 (1982) (warning against the possibility of obtaining falsely colored testimony in return for payment). *But see* No. 10575, 1980 Supp. to Digest of Bar Assn. Ethics Ops. (assuming the ethical propriety of a trial counsel testifying on behalf of a client, it is not improper that representation be on a contingent fee basis).

Plaintiffs have cited an Informal Opinion of the Los Angeles County Bar Association, No. 1972-1, to show that contingency fees for attorney witnesses are not always improper. The Association said that where the attorney has already made a determination that despite the possibility that he will be called to testify as a witness on behalf of his client, circumstances require him to undertake the representation of his client, a contingent-fee arrangement is not im-

proper. However, there has been no determination that Swan is so important to this case that he has to take on the employment. In addition, the Informal Opinion, even if relevant, is not controlling here.

Thus, whether or not Swan is performing legal services for the plaintiffs, payment contingent upon the outcome of this case violates Rule 7–109(C) which prohibits contingent fees for witnesses.[8]

The Antecedent Interest Exception

Even if the Swan Agreement violates Rule 7–109(C) of the Code of Professional Responsibility, plaintiffs claim that the Rule should not be applied to Swan because he had an antecedent interest in this action—a claim for interference with economic advantages he would have realized in *Cresswell I* but for the fraud alleged, which he traded in for the contingency fee. They cite New York decisional law, *Wellington v. Kelly*, 84 N.Y. 543 (1881), to

8. Plaintiffs argue that the ABA Model Code was replaced in 1983 by the ABA Model Rules, so that DR 7–109(C) no longer applies. However, as seen, the New York State Bar Association has never adopted the ABA Model Rules, *supra*, at n. 7, and thus 7–109(C) is still law in New York. But even if the Model Rules *were* law in this jurisdiction, payment of a contingency fee to Swan would still violate the new Rule, for 3.4(B) provides: "[a] lawyer shall not ... offer an inducement to a witness that is prohibited by law." Here, case law prohibits contingency fees to witnesses.

sanction a contingent fee arrangement with a witness who is possessed of an antecedent interest. In *Wellington*, Hill had paid a certain mortgage and received a satisfaction piece. Thereafter, he entered into an agreement with persons exposed to foreclosure of the mortgage, pursuant to which he would furnish papers and documents necessary to defeat the foreclosure action in return for a contingent fee equal to one-half the amount of the mortgage. Hill's assignee sued to recover upon this contingent fee. According to the court:

> Hill was not a stranger in interest to the subject of this litigation. His antecedent relation to the mortgage made it just that he should be indemnified.... The mere fact that the [contingency fee] agreement might furnish a temptation to Hill to prevaricate, or furnish false testimony does not ... stamp the agreement as illegal *per se*, and no illegal or improper intent on the part of any of the parties, is disclosed by the evidence.

Wellington, however, is not only an antique, it is not dispositive. Hill's antecedent interest in *Wellington* is not comparable to Swan's, whose interest, as an attorney, did not exist separate from the interest of the *Cresswell I* plaintiffs. Moreover, when *Wellington* was decided, Rule 7–109(C) of the Code of Professional Responsibility did not exist. Further, in

Wellington, it is a question of certified copies of documents that is at issue, and not testimony. Finally, Swan's antecedent interest in this case is entirely conditional and has not been established either as to amount or eventuality.

To establish Swan's antecedent claim, the plaintiffs claim first that an agent who contemplates benefits under a contract may claim against a third party who interferes by fraudulent means, and second, that defendants were liable to Swan under the *Ultramares* principles governing liability for fraud. *See Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931) (Cardozo, J.).

To support the first contention, plaintiffs cite *Lurie v. New Amsterdam*, 270 N.Y. 379, 1 N.E.2d 472 (1936) and *Hornstein v. Podwitz*, 254 N.Y. 443, 173 N.E. 674 (1930). However, in those cases, the action was against third parties who induced a principal to breach a contract with the agent thus depriving the agent of monies due from the principal, whereas in this case, the principals—the *Cresswell I* clients—paid Swan his fee in full for his *Cresswell I* work. Thus, the cases supporting the first theory do not apply here.

The *Ultramares* principle also does not apply, despite its holding that a plaintiff can sue defendant for fraud even where no privity exists. *Ultramares*, 255 N.Y. 170, 174 N.E. 441. *See also State Street Trust*

Co. v. Ernst, 278 N.Y. 104, 112, 15 N.E.2d 416, *reh'g denied*, 278 N.Y. 704, 16 N.E.2d 851 (1938) (accountants are liable to parties not in privity because "heedlessness and reckless disregard of consequence may take the place of deliberate intention"); *Peerless Mills, Inc. v. American Telephone & Telegraph Company*, 527 F.2d 445, 450 (2d Cir.1975) ("[a] third party can recover damages for a fraudulent misrepresentation if he can establish that he relied upon it to his detriment, and that the defendants intended the misrepresentation to be conveyed to him") (footnote omitted); *Berkowitz v. Baron*, 428 F.Supp. 1190, 1196 (S.D.N.Y.1977) ("plaintiffs must prove that Markowe knowingly made false representations of material fact with the intent to deceive investors and induce them to rely thereon, and that plaintiffs did rely on the representations to their detriment"); *American Electric Power Company, Inc. v. Westinghouse Electric Corporation*, 418 F.Supp. 435, 450 (S.D.N.Y.1976) (a plaintiff may recover for defendant's alleged fraudulent misrepresentations upon a showing that plaintiff was within the class of persons whom the defendant should reasonably have expected would rely on the statements, and where the plaintiff in fact relied); Restatement of Torts, Second, § 531 ("[o]ne who makes a fraudulent misrepresentation is subject to liability to the persons or class of persons whom he intends or has reason to expect to act or

refrain from action in reliance upon the misrepresentation....").

Although Bache and Sullivan and Cromwell might well have expected Swan's reliance on their alleged misrepresentations, and because Swan is alleged to have relied on them, Swan may have an independent fraud claim pursuant to *Ultramares* if it is established that but for the fraud, a greater recovery and consequently a greater fee would have been received. As set forth below, such is not the case.

Thus, Swan has no antecedent interest in this case. Any reliance by him on defendants' statements was only in his capacity as plaintiffs' agent, and his independent claim against defendants, if any, is not antecedent.[9]

CPLR § 4512

Even if the antecedent interest exception fails, plaintiffs argue that the Rule 601 of the Federal Rules of Evidence and New York CPLR § 4512 support their contention that Swan's fee is not improper. According to Rule 601, state law determines whether an individual can be a witness in a state law claim. The relevant New York law is CPLR 4512, which states:

> [e]xcept as otherwise expressly prescribed, a person shall not be excluded or excused from being a witness, by reason

9. If *Cresswell I* plaintiffs recover additional sums in this case, Swan might have an action in contract against them.

of his interest in the event or because he is a party....

Thus, plaintiffs contend, Swan's contingent fee arrangement is not prohibited.

However, as seen, Rule 7-109(C) "expressly prescribes" a person from testifying as a witness when he or she has a contingent interest in the outcome of the case. *See Person v. Association of the Bar of the City of New York*, 554 F.2d 534, 536, 538 (2d Cir.), *cert. denied*, 434 U.S. 924, 98 S.Ct. 403, 54 L.Ed.2d 282 (1977). Further, as part of the ABA Code of Professional Responsibility, Rule 7-109(C) has been recognized in New York "as providing appropriate guidelines for proper professional behavior." *Fund of Funds v. Arthur Andersen & Co.*, 567 F.2d at 227 n. 2, *citing NCK Organization, Ltd. v. Bregman*, 542 F.2d at 129 n. 2. Thus, the payment to Swan of a contingency fee is improper. While it is true, as plaintiffs argue, that "[t]he code provisions cannot be applied as if they were controlling statutory or decisional law," Rule 7-109(C) will be applied here in the absence of conflicting authority.

Invalidation of the Swan Agreement

The conclusion that the Swan Agreement is improper presents four alternatives: (1) dismissal of the case, (2) disqualification of Swan and/or Cooper as counsel to plaintiffs in this action, (3) pre-

clusion of Swan's testimony, and (4) invalidation of the Swan Agreement. Bache does not request dismissal, but instead urges that Swan's testimony be precluded, and cites *Cosgrove v. Sears Roebuck and Co., supra*, for the proposition that testimony should be excluded when Rule 7-109(C) has been violated. *Cosgrove*, however, is distinguishable on the grounds that the court precluded the testimony of an expert witness, where the only injury to the opposing party was the delay which it would take to hire a new expert.

Bache also cites *In re Mushroom Transp. Co., Inc.*, 70 B.R. 416, 70 Bankr.L. Rep. 416 (Bankr.E.D.Pa.1987), in which the Court barred the testimony of an individual who was hired to assist the debtor in the collection of sums in return for a court-approved contingency fee. However, in *Mushroom*, the Court relied primarily on Pennsylvania law to exclude the testimony, although it did make reference to Rule 7-109(C).

Swan and counsel to the plaintiffs have already considered the possibility that their agreement will be held unethical. The Swan Agreement provides that if the arrangement is held improper, Swan's entitlement to payment will be reduced or modified. However, Bache and Sullivan and Cromwell claim that it is too late to use this provision in the Agreement. Because defendants have already taken Swan's deposi-

tion and because "Swan's deposition testimony, to which he will undoubtedly adhere at trial, is indelibly tainted by the strong financial inducement he has been given to support plaintiff's claims," they contend that preclusion of his testimony is the only solution. Of course, Swan's credibility, fee or no, will certainly be at issue if his testimony is permitted.

The principal difficulty is that Swan's testimony on the facts provides direct evidence as to the conduct of the defendants. If motions to disqualify attorneys require "judicial scrutiny to prevent literalism from ... overcoming substantial justice to parties," *J.P. Foley & Co., Inc. v. Vanderbilt*, 523 F.2d 1357, 1360 (2d Cir.1975) (Gurfein J. concurring), quoted in *Norman Norrell, Inc. v. Federated Department Stores, Inc.*, 450 F.Supp. 127, 130 (S.D.N.Y.1978), such scrutiny is especially necessary here, where an effort has been made to preclude critical fact testimony. Substantial justice requires the testimony.

However, as long as Swan will be a central witness in this case, he cannot provide legal services to *Cresswell II* plaintiffs. Although it is unusual to disqualify a lawyer-witness who is limiting services to out-of-court assistance, *see e.g., Bottaro v. Hatton Associates*, 680 F.2d 895 (2d Cir. 1982); *Norman Norell, Inc. v. Federated Department Stores*, 450 F.Supp. 127 (S.D. N.Y.1978); *Ross v. Warthen*, No. 84 Civ.

4009 (CSH) (S.D.N.Y. Feb. 11, 1987), [1987 WL 7025] 1987 U.S. Dist. LEXIS 1078, Swan will be a key fact witness here. His work on the case raises the "threat of tainting the trial." *Bottaro*, 680 F.2d at 896. Further, in order not to run afoul of the terms of Rule 7-109(C), the Swan Agreement must be invalidated in its entirety. Because it is necessary to "avoid even the appearance of impropriety," Code of Professional Responsibility, Canon 9, and because no particular hardship to plaintiffs will be caused by Swan's disqualification if he is permitted to testify, Swan must not serve as plaintiffs' attorney, and cannot receive a contingent fee in this action.

The Propriety of Summary Judgment

An appropriate grant of summary judgment requires the absence of any material issue of fact. In making this determination, all inferences and ambiguities must be resolved in favor of the opposing party. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). However, "the mere existence of factual issues—where those issues are not material to the claims before the court—will not suffice to defeat a motion for summary judgment." *Knight v. U.S. Fire Insurance Co.*, 804 F.2d 9, 11-12 (2d Cir.1986), *cert. denied*, 480 U.S. 932, 107 S.Ct. 1570, 94 L.Ed.2d 762 (1987) (quoting *Quarles v. General Motors Corp.*, 758 F.2d 839, 840 (2d Cir.1985) (*per curiam*)).

The elements of the plaintiffs' claim, common law fraud, are well understood: "a material, false representation, an intent to defraud thereby, and reasonable reliance on the representation, causing damage to the plaintiff." *Katara v. D.E. Jones Commodities, Inc.*, 835 F.2d 966, 970–71 (2d Cir.1987) (citations omitted). Essentially, these elements can be reduced to three here: (1) whether Sullivan and Cromwell intended to defraud plaintiffs by withholding documents; (2) whether the representation that Sullivan and Cromwell produced all documents responsive to the second document request had a material detrimental impact on plaintiffs; and (3) whether the plaintiffs relied on Sullivan and Cromwell's misrepresentation to their detriment. The standard for proving each element is clear and convincing evidence. *Ajax Hardware Mfg. Corp. v. Industrial Plants Corp.*, 569 F.2d 181, 186 (2d Cir.1977); *Lester v. Pickwick International, Inc.*, 528 F.Supp. 1011, 1013 (E.D.N.Y.1981); *Simcuski v. Saeli*, 44 N.Y.2d 442, 452–53, 377 N.E.2d 713, 718–19, 406 N.Y.S.2d 259, 265 (1978); *Manchel v. Kasdan*, 286 A.D. 483, 484, 144 N.Y.S.2d 694, 695 (1st Dept.1955), *aff'd*, 1 N.Y.2d 734, 134 N.E.2d 687, 151 N.Y.S.2d 940 (1956).

Therefore, this court must inquire "as to . . . whether the evidence presented is such that a jury applying that evidentiary standard could reasonably find for either the

plaintiff or the defendant." *Anderson v. Liberty Lobby*, 477 U.S. at 255–56, 106 S.Ct. at 2514. If plaintiffs cannot meet their burden as to even one element of their claim, summary judgment for Sullivan and Cromwell must be granted. *Lehman v. Dow Jones & Co.*, 783 F.2d 285, 295–96 (2d Cir.1986); *Seven Star Shoe Co., Inc. v. Strictly Goodies, Inc.*, 657 F.Supp. 917, 920 (S.D.N.Y.1987).

In these circumstances the principal underlying issue is the responsibility of lawyers in pretrial discovery, the effect of that conduct on the opposing counsel, and the mechanics by which securities claims are settled. It is this aspect of the controversy which makes it particularly appropriate for judicial rather than jury determination, providing, of course, there is no material fact at issue that would provide, if determined in favor of the plaintiffs, clear and convincing evidence of fraud by Sullivan and Cromwell.

Intent

To defeat a motion for summary judgment bottomed on lack of intent, plaintiffs must adduce clear and convincing evidence that a material issue of fact exists as to whether Sullivan and Cromwell intended to defraud the plaintiffs by failing to comply with discovery demands and withholding documents responsive to Swan's Second Document Request. It is not enough for plaintiffs to establish simply that doc-

uments responsive to the demand were not produced. *See, e.g., Perma Research and Development Co. v. Singer Co.*, 410 F.2d 572, 576 (2d Cir.1969) ("actionable fraud depends on more than a showing of nonperformance"); *DiRose v. PK Management Corp.*, 691 F.2d 628, 632–33 (2d Cir. 1982), *cert. denied*, 461 U.S. 915, 103 S.Ct. 1896, 77 L.Ed.2d 285 (1983), *quoting Lanzi v. Brooks*, 54 A.D.2d 1057, 388 N.Y.S.2d 946 (3d Dep't 1976), *aff'd* 43 N.Y.2d 778, 373 N.E.2d 278, 402 N.Y.S.2d 384 (1977) ("[u]nder New York law, any inference drawn from the fact that the expectation did not occur is not sufficient to sustain the plaintiff's burden of showing that the defendant falsely stated his intentions"); *Lang v. Warner*, 121 A.D.2d 514, 504 N.Y. S.2d 18, 19 (2d Dept 1986) ([w]here complaint did not contain factual assertions from which a conclusion of intent could be drawn, complaint failed to state a cause of action in fraud).

The issue of intent in a fraud case is rarely susceptible of direct proof. Therefore, fraud ordinarily must be established by circumstantial evidence "and the legitimate inferences arising therefrom." *Goshen Litho Inc. v. Kohls*, 582 F.Supp. 1561, 1564 (S.D.N.Y.1983). *See also, Rea v. Missouri*, 84 U.S. (17 Wall.) 532, 543, 21 L.Ed. 707 (1873) ("[t]o establish fraud, it is not necessary to prove it by direct and positive evidence. Circumstantial evidence

is not only sufficient, but in most cases it is the only proof that can be adduced"); *United States v. Panza*, 750 F.2d 1141, 1149 (2d Cir.1984) (fraudulent intent is often established by circumstantial evidence).

According to the plaintiffs, the circumstances of the failure to produce the December 5 and December 9 letters, the Polly Gregory documents, the letter of July 11, the CBOT letter announcing the end of its investigation, the summary of the meeting with the London Department of Trade, the *Kotz* decision and other reported decisions raise an issue of material fact as to Sullivan and Cromwell's intent.

There is no evidence that Sullivan and Cromwell knew about the December 5 letter from the NYSE Enforcement Investigator and the December 9 letter in which Bache acknowledged receipt of the December 5 letter, or acquired any knowledge of the investigation until after *Cresswell I* was settled. Plaintiffs' contention that a jury could infer Sullivan and Cromwell's knowledge of the NYSE investigation from Sullivan & Cromwell's many phone calls to Bache during the relevant time period is mere speculation. *See H.L. Moore Drug Exchange v. Eli Lilly & Co.*, 662 F.2d 935, 941 (2d Cir.1981), *cert. denied*, 459 U.S. 880, 103 S.Ct. 176, 74 L.Ed.2d 144 (1982), *quoting Oreck Corp. v. Whirlpool Corp.*, 639 F.2d 75, 79 (2d Cir.1980), *cert. denied*, 454 U.S. 1083, 102 S.Ct. 639, 70 L.Ed.2d 618

(1981) (showing of close relations or frequent meetings between alleged conspirators cannot sustain plaintiff's burden to prove conspiracy). Apparently, Bache's policy that all information concerning the Spreads would be handled in-house prevented Sullivan and Cromwell from receiving copies of all of the letters. Indeed, the General Counsel of Bache testified that he does not recall thinking it advisable to inform Sullivan and Cromwell of the December 5 letter.

There is a material question of fact, however, as to whether intent can be inferred from Sullivan and Cromwell's narrow interpretation of the discovery request and the subsequent failure to turn over the Polly Gregory documents. Having conferred with Salmanson, Schwartz was well aware of the Bache response of June 8, 1983. It is conceded that the documents related to this stage of the NYSE investigation were in Sullivan and Cromwell's files (Plaintiff's Mem. of Facts at 28). Sullivan and Cromwell argues that Schwartz's withholding of the earlier documents was a conscious decision based upon a permissible interpretation of the discovery request. *See, e.g., USM Corp. v. SPS Technologies, Inc.*, 694 F.2d 505, 509 (7th Cir.1982), *cert. denied*, 462 U.S. 1107, 103 S.Ct. 2455, 77 L.Ed.2d 1334 (1983) (condoning the "well-nigh universal practice" of construing an adversary's discovery request narrowly); *Rau-*

enhorst v. United States, 104 F.R.D. 588, 600 n. 18 (D.Minn.1985) (indicating that narrowly construing a discovery request would have been proper). However, Schwartz's interpretation of "inquiry or investigation" is not in accord with its ordinary meaning, and, in the particular context of this case, could raise an inference of intent to withhold documents fraudulently, especially where the documents were not produced even after the NYSE action became public. In addition, the inconsistency between the explanation of Schwartz and Hardiman as to the consciousness of the decision not to produce the Polly Gregory documents raises an issue of fact as to whether there was a conscious decision to withhold on a basis other than that now urged by Schwartz.

Sullivan and Cromwell contends that its actions belie fraudulent intent, because Burnett, marked several of the Polly Gregory documents at her deposition, questioned her about them and specifically stated that the documents came from Sullivan and Cromwell's files. Some had not been included in the response to the Second Document Request. Sullivan and Cromwell requested production of additional documents from Gregory and followed up on the request by letter and finally by motion in order to compel production of the documents. Although Sullivan and Cromwell's acts in the spring of 1984 constitute

a compelling refutation of a consistent intent to defraud, they do not remove a question of fact as to whether a responsive document was intentionally withheld in December 1983.

As for the July 11, 1984 letter from Bache to the Exchange, plaintiffs contend that the letter, which was addressed to the Department of Enforcement, proves that Schwartz knew of the existence of the investigation, and thus knew that his earlier interpretation was incorrect and that his December 1983 representation to *Cresswell I* plaintiffs was false. Additionally, plaintiffs claim that because Sullivan and Cromwell knew of the Exchange investigation before *Cresswell I* settled and did not disclose it, and because Sullivan and Cromwell's representation had been that all responsive documents were produced, a jury could infer intent. Drawing all inferences on behalf of plaintiff, a question of fact exists as to whether Sullivan and Cromwell intended to defraud the plaintiffs in *Cresswell II* by withholding the July 11, 1984 Letter in hopes of achieving a settlement before the results of the inquiry became known, which is, of course, what happened.

Although Fed.R.Civ.P. 26(e) provides that there is generally "no duty to supplement" a discovery response in the absence of an "order of the court, agreement of the parties, or ... new requests for supplementation," Fed.R.Civ.P. 26(e) and (e)(3), and

although there was no such instruction included in the Second Request in *Cresswell I* or in the litigation against Bache, by July 1984 Sullivan and Cromwell knew that even under its own narrow interpretation of the Second Document Request its earlier response was inaccurate or incomplete. A duty to amend the response at that point existed. *See* Fed.R.Civ.P. 26(e) & Advisory Committee Note thereto; *Petroleum Ins. Agency, Inc. v. Hartford Accident & Indem. Co.*, 106 F.R.D. 59 (D.Mass.1985).

In addition, the failure of Sullivan and Cromwell to produce the NYSE documents in the *Merana* and the *Reitz* cases, Hardiman's inability to locate the documents in March of 1986, the absence of Schwartz's draft of the June 8, 1983 Salmanson letter, and the later concession that the documents were in Sullivan and Cromwell's possession all fortify the inference of intentional withholding. While the *Reitz* response might have been subject to a work product privilege, documents responsive to the demand were known and withheld, and no such privilege was asserted.

As for other documents, Sullivan and Cromwell point out the irony that among the documents pointed to by plaintiffs as being fraudulently withheld is one which would have been to Bache's advantage, for it indicated that the CBOT's inquiry into the Spreads was completed, without a finding of any wrongdoing by Bache. Sullivan

and Cromwell's arguments are persuasive as to the withheld CBOT documents and the publicly reported *Kotz* decision. However, even if Sullivan and Cromwell failed to consider the NYSE investigation while considering settlement in *Cresswell I* in 1985, there remains an inference which could be drawn that the firm acted with an intent to deceive when it represented to plaintiffs that all documents responsive to the Second Document Request had been turned over. Hence, summary judgment cannot be granted to Sullivan and Cromwell on the grounds of a lack of intent.

Materiality

Although it has been established that a triable issue of fact exists as to whether Sullivan and Cromwell intended to withhold documents, Sullivan and Cromwell can still prevail on their motion for summary judgment if plaintiffs fail to establish that an issue of fact exists as to whether the withheld documents were material.

In Paragraph 35 of the Second Amended Complaint, plaintiffs allege that withheld documents were material:

> Knowledge of the Exchange Investigation and the consequential measures that would have been taken by Swan if he had had such knowledge, would greatly have strengthened the chances of the Prior Plaintiffs for success at trial. This would greatly have strengthened the Pri-

or Plaintiff's bargaining position vis-a-vis Bache in the settlement negotiations.

Because there is no evidence to indicate that Sullivan and Cromwell knew about the December 5 or December 9 letters when responding to plaintiffs' Second Document Request, the Polly Gregory documents and the Letter of July 11, 1984 are the relevant documents to consider.

The standard for materiality in a fraud case is that the matter allegedly misrepresented must be reasonably certain to have a substantial effect on the plaintiff's decision. *Quintel Corp. v. Citibank*, 606 F.Supp. 898, 906 (S.D.N.Y.1985). Further, to be material, the information withheld "[m]ust go to the essential factual essence of the transaction." *Benz v. Kaderbeck*, 241 A.D. 583, 585, 272 N.Y.S. 558, 561 (4th Dep't 1934); *Uhlmann v. Hammons*, 74 N.Y.S.2d 66, 67 (Sup.Ct.N.Y.Co.1947). *See also Metropolitan Life Ins. Co. v. Union Trust Co.*, 268 A.D. 474, 482–83, 51 N.Y.S.2d 318, 325–26 (4th Dep't 1944), *aff'd*, 294 N.Y. 254, 62 N.E.2d 59 (1945) ("[i]t is not possible now to charge the defendant for failing to disclose what did not appear to be material at the time, and as to which there is no substantial evidence that the plaintiff considered it material.").

According to the plaintiffs, the withheld documents were material as establishing the existence of the Exchange investigation. Plaintiffs also urge that the amounts of subsequent settlements between Bache

and investors establish by inference the materiality of the Exchange investigation. Finally, plaintiffs contend that a jury could infer materiality simply from the fact that Sullivan and Cromwell withheld the documents.

Although Swan, in his letter to the *Cresswell I* plaintiffs recommending settlement, explained that the issue in *Cresswell I* was whether plaintiffs, sophisticated investors, reasonably relied on the alleged misrepresentations—mostly oral—as to the risk associated with the Spreads transaction, and although Shippy, the Exchange official who handled the Exchange investigation, testified that the NYSE investigation into the marketing of the Spreads had "nothing to do with the individuals who were suing the firm," the test for materiality, unlike that for intent and reliance, is an objective one. *Quintel Corp. v. Citibank*, 606 F.Supp. at 906. In addition to the Polly Gregory documents, the July 11, 1984 letter from Bache to the Department of Enforcement evidenced that the NYSE Department was investigating the marketing of the Spreads. Whether knowledge of the existence of regulatory activity on the part of the NYSE was material depends not upon the perceptions of Swan or of Shippy, but rather on whether the information would have been reasonably certain to have had a substantial effect on a reasonable person. Once the reasonableness standard is introduced, it is difficult to deny that there is a

factual issue as to the effect of an investigation by a regulatory body.

The settlements in *Merana* and *Reitz* which were completed after the public announcement of the NYSE decision accomplished a return in relation to claim significantly larger than that achieved by the settlement in *Cresswell I*. While *Cresswell I* plaintiffs settled for 46% of their claims, *Merana* settled for 93.99% of claimed losses, and *Reitz* settled for 71%, after Swan told Hardiman "that the New York Stock Exchange decision changes matters entirely." The 71% settlement in *Reitz* occurred despite the fact that there was little discovery and no depositions in that case. These settlements constitute objective evidence to support the inference that knowledge of the NYSE investigation was material. *See Securities & Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir.1968), *cert. denied*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969). While the settlements in *Merana* and *Reitz* are not admissible to prove Bache's liability pursuant to Rule 408 of the Federal Rules of Evidence, *United States v. Gilbert*, 668 F.2d 94, 97 (2d Cir. 1981), *cert. denied*, 456 U.S. 946, 102 S.Ct. 2014, 72 L.Ed.2d 469 (1982), they have probative value with respect to materiality, intent and reliance.

The circumstances surrounding the settlement of *Merana* and *Reitz* differed from *Cresswell I* in aspects other than the public

knowledge of the NYSE action. They were the tail end of the litigation; the plaintiff in *Merana* filed an amended complaint including new claims, based more on negligence than on fraud; Berger, a different lawyer, pursued additional discovery, and had retained an expert witness; unlike the plaintiffs in *Cresswell I*, the plaintiffs in *Reitz* and *Merana* had not signed risk disclosure statements; and the German brochure used to market the Spreads to the plaintiffs in these cases was even less favorable to the Bache position. Notwithstanding these differences, the existence of these larger later settlements raises a triable inference that knowledge of the NYSE investigation was material.

The plaintiffs have support for the proposition that materiality can be inferred from nonproduction of the documents by Sullivan and Cromwell. *Consolidated Rail Corporation v. Nevins-Petrillo Warehouse & Distribution Systems, Inc.*, 619 F.Supp. 900, 906 (S.D.N.Y.1983). The inference of materiality from nonproduction turns again in large measure on the intent of Sullivan and Cromwell, already found above to constitute an issue of fact. While under other circumstances nonproduction might not infer materiality, here at least an issue of fact exists.

The effect of the existence of an investigation by a regulatory body, the greater amounts paid for settlement after the results of the investigation became known,

and the withholding of the information concerning the investigation, all raise a factual issue as to whether or not the withheld information was material. Summary judgment dismissing the complaint on the basis of the absence of such an element must therefore be denied.

Reliance and Loss Causation

Even if Sullivan and Cromwell intentionally withheld documents, and even if the withheld documents were material, Sullivan and Cromwell's motion for summary judgment will be granted because the plaintiffs fail to raise a triable issue of fact with respect to the required element of reliance. *Lehman v. Dow Jones & Co., Inc.*, 783 F.2d 285, 295–96 (2d Cir.1986); *Seven Star Shoe Co., Inc. v. Strictly Goodies, Inc.*, 657 F.Supp. 917, 920 (S.D.N.Y.1987). In addition, plaintiffs have to show that the loss was "the direct, immediate, and proximate result of the fraudulent misrepresentation." *Goldberg v. Mallinckrodt, Inc.*, 792 F.2d 305, 307 (2d Cir.1986).

Swan knew not only about the Polly Gregory exchange but that Sullivan and Cromwell had not produced them in response to his request. By June, 1984, at Gregory's deposition, Swan knew that Bache had corresponded with the NYSE, and that Sullivan and Cromwell had in its possession documents which Swan considered to be responsive to the Second Doc-

ument Request, but which had not been produced. Swan conceded that at least one of the documents marked by Burnett was responsive to his Second Document Request and had not been produced. Despite this, Swan did not ask Burnett—or anyone else at Sullivan and Cromwell—why any of the documents had not been produced in response to the Second Document Request or for the Polly Gregory file, nor was his document demand renewed or amended.

Under these circumstances, even if Swan did rely on Sullivan and Cromwell's representation, and even if he believed that the failure to turn over the documents was an inadvertent omission, his reliance on Sullivan and Cromwell's representation was not reasonable. He never sought to depose Goldenblum, although he knew that Goldenblum had communicated with the Exchange. He did not contact the Exchange, even though he knew that the Exchange sometimes examined customer complaints. He did not contact the CBOT—the Exchange on which the Spreads were traded—about its investigation, nor did he discuss the activities of regulatory bodies with his clients or even with his associate. For all of these reasons, Swan could not have reasonably relied on Sullivan and Cromwell's response.

If the facts misrepresented "are not matters peculiarly within the party's knowledge, and the other party has the means

available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations." *Cudemo v. Al. & Lou Construction Co.*, 54 A.D.2d 995, 387 N.Y.S.2d 929, 930 (3d Dep't 1976), *quoting Danann Realty Corp. v. Harris*, 5 N.Y.2d 317, 322, 157 N.E.2d 597, 600, 184 N.Y.S.2d 599, 603 (1959) (*quoting Schumaker v. Mather*, 133 N.Y. 590, 596, 30 N.E. 755, 757 (1892)). Similarly, if plaintiff "has been furnished with the means of knowledge and he is not prevented from using them he cannot say he has been deceived by the misrepresentations of the other party." *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir.1975). *See also Rauenhorst v. United States*, 104 F.R.D. 588, 603 (D.Minn.1985) (where certain documents could have led plaintiffs to discover that information was withheld, but where plaintiffs did nothing, they could not claim to have acted in reliance upon the misrepresentations).

Swan's conclusory declaration that he relied upon Sullivan and Cromwell's representation is overcome by the undisputed facts set forth above. *See United States v. DeFilippo*, 647 F.Supp. 1355, 1358 (S.D.N.Y. 1986) (a sworn statement unsupported by facts does not warrant a finding in favor of

declarant); *Sanders v. Douglas*, 565 F.Supp. 78, 80–87 (C.D.Cal.1983) ("[a]n affidavit containing ultimate facts or conclusions of law cannot defeat a summary judgment motion"). Plaintiffs have failed to establish reasonable reliance, and Sullivan and Cromwell's motion for summary judgment is thus granted.

Gross Negligence

In addition to the fraud claim, Sullivan and Cromwell have moved for summary judgment on plaintiffs' gross negligence claim. Like the fraud claim, a gross negligence claim requires proof of misrepresentation, reasonable reliance, materiality, causation and injury. *See International Products Co. v. Erie R. Co.*, 244 N.Y. 331, 338–39, 155 N.E. 662, 664, *cert. denied*, 275 U.S. 527, 48 S.Ct. 20, 72 L.Ed. 408 (1927). Here, as in the fraud claim, plaintiffs have failed to offer evidence sufficient to support a material issue of fact as to materiality of the withheld documents or reasonable reliance on Sullivan and Cromwell's misrepresentation.

In addition, an attorney does not owe a duty of care to the adversary of the client. *National Savings Bank v. Ward*, 100 U.S. (10 Otto) 195, 200, 25 L.Ed. 621 (1880), *Hakala v. Van Schaick*, 171 Misc. 418, 425, 12 N.Y.S.2d 928, 935 (1939). "It is well-settled that an attorney may not be held liable for negligence in the provision of professional services adversely affecting one with

whom the attorney is not in contractual privity." *National Westminster Bank v. Weksel*, 124 A.D.2d 144, 146, 511 N.Y.S.2d 626, 628 (1st Dep't), *app. denied*, 70 N.Y.2d 604, 513 N.E.2d 1307, 519 N.Y.S.2d 1027 (1987). *See also Felson v. Miller*, 674 F.Supp. 975, 978–79 (E.D.N.Y.1987) (absent privity of contract or "special circumstances," trust beneficiary could not sue trustee under New York law).

Finally, in this court's opinion of July 1987, it was determined that a fraud case could be maintained against Sullivan and Cromwell because of the need to deter fraud, *Cresswell v. Sullivan and Cromwell*, 668 F.Supp. 166, 172 (S.D.N.Y.1987). However, this court did not sanction a claim for gross negligence by the settling party against the attorneys for other settling party. Thus, under Fed.R.Civ.P. 60(b), the negligence claims should be dismissed.

Punitive Damages

Because summary judgment dismissing the fraud and gross negligence claims is granted, there is no need to determine whether punitive damages are available.

Amendment of the Complaint

Plaintiffs have moved to further amend their Second Amended Complaint to add a claim for relief under § 487 of the

New York Judiciary Law.[10] As Fed.R.Civ. P. 15(a) provides, leave to amend a complaint should be "freely given." However, it is not granted in every case, since "leave to amend should be permitted *in the absence of an apparent or declared reason*, such as undue delay, bad faith, or undue prejudice to the opposing party." *Tokio Marine & Fire Insurance Co. v. Employers Insurance of Wausau*, 786 F.2d 101, 103 (2d Cir.1986) (quoting *Foman v. Davis*, 371 U.S. 178, 182, 83 S.Ct. 227, 230, 9 L.Ed.2d 222 (1962) (emphasis added)).

Plaintiffs' first complaint was filed in April, 1987, the Amended Complaint in May, 1987, and the Second Amended Complaint in March, 1988. On September 30, 1988, nearly three months after Sullivan and Cromwell moved for summary judgment, plaintiffs sought, once again, to amend their complaint.

10. According to § 487:

> An attorney or counselor who:
>
> 1. Is guilty of any deceit or collusion, or consents to any deceit or collusion, with intent to deceive the court or any party; or,
>
> 2. Wilfully delays his client's suit with a view to his own gain; or, wilfully receives any money or allowance for or on account of any money which he has not laid out, or becomes answerable for,
>
> Is guilty of a misdemeanor, and in addition to the punishment prescribed therefor by the penal law, he forfeits to the party injured treble damages, to be recovered in a civil action.

When a motion for summary judgment is pending, courts have denied leave to amend on grounds of undue delay and prejudice. *See, e.g., Layfield v. Bill Heard Chevrolet Co.*, 607 F.2d 1097, 1098–99 (5th Cir.1979) (per curiam), *cert. denied*, 446 U.S. 939, 100 S.Ct. 2161, 64 L.Ed.2d 793 (1980); *Kirby v. P.R. Mallory & Co.*, 489 F.2d 904, 912 (7th Cir.1973), *cert. denied*, 417 U.S. 911, 94 S.Ct. 2610, 41 L.Ed.2d 215 (1974). Here, Sullivan and Cromwell moved for summary judgment on all claims in July. The motion to amend was made on September 30. Although a court "may not properly deny an amendment solely on the ground of delay," the burden is on the movant "to show 'some valid reason for his neglect and delay.'" *Sanders v. Thrall Car Mfg. Co.*, 582 F.Supp. 945, 953 (S.D.N.Y.1983), *aff'd*, 730 F.2d 910 (2d Cir.1984), *quoting Hayes v. New England Millwork Distributors, Inc.*, 602 F.2d 15, 19–20 (1st Cir.1979) (*quoting Freeman v. Continental Gin Co.*, 381 F.2d 459, 469 (5th Cir.1967)).

According to the declaration submitted by counsel for the *Cresswell II* plaintiffs, the reason that no claim under § 487 was included in the first Complaint, the Amended Complaint, or the Second Amended Complaint is that he "first became aware of it in the course of preparing papers in opposition to the pending motion for summary judgment." However, where a plaintiff "advances no reason for his extended and undue delay other than ignorance of the law, such a failure has been held an insuffi-

cient basis for leave to amend." *Goss v. Revlon, Inc.*, 548 F.2d 405, 407 (2d Cir. 1976).

The statute at issue here is not new—indeed, Sullivan and Cromwell points out that it has been in force "in substantially its present form" for over a century. Mem. at 4. *See also Sanders v. Thrall Car Manufacturing Co.*, 582 F.Supp. at 952-53 (where plaintiff moved to amend complaint to add a statute enacted nearly a decade earlier on the grounds that counsel for plaintiff had been unfamiliar with the statute, court refused to allow amendment). Further, no authority has yet found the statute applicable in circumstances such as these. The language of the statute speaks in terms of obstruction of justice rather than a deliberate failure to comply with discovery requirements, unimaginable at the time of statutory enactment.

Thus, because plaintiffs have waited too long to seek this amendment, and because to allow the amendment at this late stage would unduly prejudice Sullivan and Cromwell and because the amended claim would raise or fall on the initial allegations, the motion to further amend the complaint is denied.

Consolidation of Trial

The *Meadows* plaintiffs have moved pursuant to F.R.Civ.P. 42(a) to consolidate the *Cresswell* and the *Meadows* actions on the grounds that both cases have common questions of law and fact, and that consoli-

dation will avoid unnecessary costs. Both the *Cresswell* plaintiffs and Sullivan and Cromwell oppose consolidation largely on grounds that it may delay the trial of this case. Because summary judgment has been granted, it is unnecessary to decide the issue of consolidation at this stage.

Conclusion

For the reasons set forth above, Sullivan and Cromwell's motion for summary judgment on the Second Amended Complaint is granted. Plaintiff's motion to amend the Second Amended Complaint, the *Meadows* plaintiff's motion to consolidate, and Bache's motion to preclude the testimony of Swan are denied.

It is so ordered.